

# Old Torts, New Torts and Taxes: The Still Uncertain Scope of Section 104(a)(2)

Patricia T. Morgan

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Patricia T. Morgan, *Old Torts, New Torts and Taxes: The Still Uncertain Scope of Section 104(a)(2)*, 48 La. L. Rev. (1988)  
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# **OLD TORTS, NEW TORTS AND TAXES: THE STILL UNCERTAIN SCOPE OF SECTION 104(a)(2)**

*Patricia T. Morgan\**

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## I. INTRODUCTION

Section 104(a)(2) of the Internal Revenue Code<sup>1</sup> (Code) permits the exclusion from gross income of "the amount of any damages received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal injuries or sickness." Although this provision has been part of the federal income tax laws in substantially its present form since 1918,<sup>2</sup> its applicability to many types of recoveries remains unsettled. The greatest uncertainty exists with respect to recoveries that are not typically viewed as involving a traditional type of personal injury, such as recoveries under federal antidiscrimination statutes and recoveries for "wrongful discharge." Such recoveries, unknown and unanticipated when the predecessor of section 104(a)(2) was enacted, are today neither rare nor inconsequential.<sup>3</sup>

Not surprisingly, as the national debates about tort reform and tax reform have intensified and as the number and size of traditional and nontraditional recoveries have mushroomed, the Internal Revenue Service (Service) has taken an increasingly narrower view of the statutory exclusion. In recent years the Service has reversed its previous position and ruled that punitive damages are not excludable under section 104(a)(2)<sup>4</sup> and has persisted in maintaining that most business-related nonphysical injuries do not qualify for the exclusion.<sup>5</sup> Until very recently, the courts encouraged such positions by consistently ignoring the statutory language and focusing instead on whether the monetary award represented a recovery of an essentially unmeasurable form of "human capital,"<sup>6</sup> or instead on whether the recovery was intended to substitute for an otherwise taxable item, such as lost income

1. All references are to the Internal Revenue Code of 1986, as amended, 26 U.S.C.A. § 1-7872 (1986).

2. As originally enacted in 1918, the exclusion applied to:

Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.

Revenue Act of 1918, ch. 18, § 213(b)(6), 40 Stat. 1066 (1919).

3. See, e.g., *Rowlett v. Anheuser-Busch, Inc.*, 832 F.2d 194 (1st Cir. 1987) (re-viewing jury award of \$300,000 compensatory damages and \$3 million punitive damages in case against employer involving Title VII of Civil Rights Act of 1964 and 42 U.S.C. § 1981).

4. Rev. Rul. 84-108, 1984-2 C.B. 32.

5. See, e.g., Rev. Rul. 85-143, 1985-2 C.B. 55.

6. For a thorough analysis of the "human capital" issue, see Stephan, *Taxation and Human Capital*, 70 Va. L. Rev. 1357 (1984).

or compensation. The law has been so unsettled, in fact, that identically situated tort victims could be subject to differing federal income tax treatment depending on such fortuities as the victim's occupation, whether the injury was physical or nonphysical, the proof offered to substantiate the claimed damages, and the applicable state law's characterization of the damages as compensatory or punitive. Moreover, the size of the victim's award will be directly affected by whether applicable federal or state law prohibits or requires jury consideration of the tax-exempt status of the award.

The most fundamental area of uncertainty is the proper analysis by which to determine whether an injury is "personal." At least since 1922, it has been clear that "personal" injuries included both physical and nonphysical injuries.<sup>7</sup> Thus, recoveries for such "dignitary" injuries as defamation of character and alienation of affections have been tax-exempt in theory at least for more than sixty-five years. In practice, the excludability of recoveries for nonphysical injuries has been denied consistently if the recovery (whether by judgment or settlement) is based on lost earnings or otherwise taxable income. Rather than focusing on whether the nature of the claim is in tort or contract, courts have based the tax consequences of the recovery on whether the recovery appears to be a substitute for lost earnings. If a recovery for a nonphysical injury appears related to lost wages or other compensation, then the courts have consistently—and wrongly—required that the award be included in income, notwithstanding that recoveries of lost income for personal injuries are (and have been since 1918) excludable under section 104(a)(2).<sup>8</sup>

This method of separating nonphysical "personal" injury recoveries (fully excludable from income) from nonpersonal "business" recoveries (fully taxable), based on whether the recovery is tied to the recipient's lost earnings, has been endorsed uncritically by the courts for years. Two related theories or approaches have evolved. First, the court inquires "in lieu of what" were the damages awarded. If the answer to this inappropriate question is "compensation" or "earnings," then the award is taxable. Second, the court may inquire whether the injury damaged the victim's personal reputation or his business or professional reputation. If the inquiry answered in the affirmative is the latter, then the award is held taxable as not being made "on account of personal injury."

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7. Sol. Op. 132, I-1 C.B. 92 (1922), superseded by Rev. Rul. 74-77, 1974-1 C.B. 33.

8. The Service recently reaffirmed the excludability of damages representing lost wages in the context of a physical injury (the taxpayer had been hit by a bus). Rev. Rul. 85-97, 1985-2 C.B. 50.

Three recent decisions of the United States Tax Court properly reject these lines of analysis and focus instead on the nature of the alleged injury. The government filed appeals in these three decisions, however, and the most recent Tax Court decision on this question may signal a retreat by the Tax Court. In *Threlkeld v. Commissioner*,<sup>9</sup> a reviewed decision,<sup>10</sup> the Tax Court explicitly rejected the business-reputation versus personal-reputation analysis and held that "[t]here is no justification for continuing to draw a distinction, in tort actions, between damages received for injury to personal reputation and damages received for injury to professional reputation."<sup>11</sup> Thus, injury to one's reputation is always "personal," and damages recovered are fully excludable. Similarly, the Tax Court held in *Bent v. Commissioner*<sup>12</sup> that a recovery by a teacher under 42 United States Code section 1983 of an amount designed to compensate him for lost earnings is excludable under section 104(a)(2) because the injury was a personal injury. Significantly, the Third Circuit Court of Appeals affirmed this decision on December 15, 1987 and squarely aligned itself with the Ninth Circuit, the only other circuit that has addressed the issue.<sup>13</sup>

More recently, the Tax Court in *Metzger v. Commissioner*<sup>14</sup> upheld the exclusion of a portion of a settlement of various claims, including Title VII claims, brought by a college professor who alleged that she was denied tenure because of impermissible gender and national origin discrimination. The *Metzger* court distinguished a previous decision in which the Tax Court held back pay recoveries under Title VII were not eligible for exclusion under section 104(a)(2) and found that the recovery was for "personal injuries." *Metzger* is on appeal to the Third Circuit, which has affirmed the *Bent* decision.

In a decision filed September 21, 1987, the Tax Court appears to have retreated somewhat from its newly expansive view of section

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9. 87 T.C. 1294 (1986), appeal docketed, No. 87-1511 (6th Cir., May 26, 1987).

10. "Reviewed decisions" are officially-reported "regular" decisions of the United States Tax Court that have been reviewed by all nineteen judges. "Regular" decisions are those that involve an interpretation of law. "Memorandum decisions," which are not officially reported, resolve only questions of fact and apply settled legal principles. The Chief Judge reviews all "regular decisions," and selects only certain decisions for review by the full membership of the court. See generally Stand. Fed. Tax Rep. (CCH) ¶ 5801.315 (1987).

11. 87 T.C. at 1298.

12. 87 T.C. 236 (1986), aff'd, 835 F.2d 67 (3d Cir. 1987).

13. For a discussion of the decision of the Ninth Circuit decision, *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983), see *infra* text accompanying notes 108-24.

14. 88 T.C. 834 (1987), appeal docketed, No. 87-1428 (3d Cir. July 16, 1987).

104(a)(2). In *Thompson v. Commissioner*,<sup>15</sup> the court held that back pay awarded under the Equal Pay Act<sup>16</sup> was not excludable under section 104(a)(2). Citing and applying the "in lieu of what" test, the court found that back pay recoveries under the Equal Pay Act are essentially recoveries for contractual violations rather than for personal injuries. Part II of this article traces the development of the law governing taxation of personal injury recoveries and concludes that the *Threlkeld*, *Bent*, and *Metzger* decisions correctly reject the "in lieu of what" test, thereby at long last returning to the analysis demanded by the statute. Although *Bent* has been affirmed on appeal by the same circuit that will hear *Metzger*, the *Thompson* case may signal a retreat by the Tax Court.

A second area of uncertainty is the meaning of the term "damages." The statutory exclusion applies to "any damages received . . . on account of personal injuries." In a 1984 ruling,<sup>17</sup> the Service concluded that punitive damages do not qualify for the exclusion because they are intended to punish the tortfeasor rather than to restore a loss of capital. The only court that has considered this ruling rejected it as an unauthorized administrative attempt to amend section 104(a)(2).<sup>18</sup> Part III of this article analyzes the excludability of punitive damages under section 104(a)(2).

Other areas of uncertainty abound, although they are beyond the scope of this article. Perhaps the most troubling of these is the dizzying array of federal and state rules concerning whether the defendant may introduce evidence of the income tax effects on the calculation of the victim's lost earnings and whether the jury may or must be instructed that its award will be tax-free. Traditionally, juries have not been instructed on the tax-exempt nature of personal injury awards, and most courts have not permitted defendants to decrease the "lost earnings" components of damage awards via evidence of net after-tax earnings versus gross before-tax earnings.<sup>19</sup> In a 1980 decision arising under the Federal Employers' Liability Act (FELA), the Supreme Court held that in a wrongful death action arising under the FELA, federal income tax is a relevant factor in determining a defendant's lost earnings and, upon request, the jury must be instructed on the tax-exempt

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15. 89 T.C. 632 (1987), appeal docketed, Nos. 88-3801 and 88-3924 (4th Cir. Jan. 6, 1988 and Jan. 28, 1988) (consolidated).

16. 29 U.S.C.A. § 206(d) (1978).

17. Rev. Rul. 84-108, 1984-2 C.B. 32.

18. *Burford v. United States*, 642 F. Supp. 635 (N.D. Ala. 1986). Although the Justice Department filed an appeal, it dismissed the appeal on December 18, 1986.

19. See generally, Frolick, *Norfolk & Western Railway Co. v. Liepelt and Structured Tort Settlements: Tax Policy "Derailed"*, 51 *Fordham L. Rev.* 565, 583-89 (1983).

nature of the award.<sup>20</sup> The Court later characterized this holding as a "federal common law rule"<sup>21</sup> and extended it to actions arising under other federal laws.<sup>22</sup>

Other courts have applied this federal common law rule to a wide variety of actions under various federal laws.<sup>23</sup> Some federal courts have even applied the rule in diversity cases where the state law was exactly contrary to the federal rule.<sup>24</sup> Thus, the size of the victim's award will vary depending on whether his action arises under federal or state law and, if arising under the latter, whether the action is brought in state or federal court.

Others have questioned whether the generous statutory exemption is justifiable on policy grounds,<sup>25</sup> and some have concluded that the exclusion of damages for lost earnings should be repealed<sup>26</sup> and that punitive damages

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20. *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490, 100 S. Ct. 755, reh'g denied, 445 U.S. 972, 100 S. Ct. 1667 (1980).

21. *Gulf Offshore Co. v. Mobil Oil Corp.*, 453 U.S. 473, 486, 101 S. Ct. 2870, 2880 (1981).

22. See, e.g., *Gulf Offshore*, 453 U.S. 473, 101 S. Ct. 2870 (Outer Continental Shelf Lands Act); *Jones & Laughlin Steel Corp. v. Pfeifer*, 462 U.S. 523, 534, 103 S. Ct. 2541, 2549 (1983) (Longshoremen's and Harbor Workers' Compensation Act).

23. E.g., the Jones Act, *Portier v. Texaco, Inc.*, 426 So. 2d 623, 630 (La. App. 1st Cir. 1982), cert. denied, 433 So. 2d 165 (1983); Death on High Seas Act, *Stoddard v. Ling-Temco-Vought, Inc.*, 513 F. Supp. 339, 342 (C.D. Cal. 1981); Federal Tort Claims Act, *Shaw v. United States*, 741 F.2d 1202, 1206-07 (9th Cir. 1984); *Flannery v. United States*, 718 F.2d 108, 111-12 (4th Cir. 1983), cert. denied, 467 U.S. 1226, 104 S. Ct. 2679 (1984); *Harden v. United States*, 688 F.2d 1025, 1029-30 (5th Cir. 1982). Not all courts agree that the *Liepelt* rule applies in Federal Tort Claims Act cases, however. See, e.g., *Barnes v. United States*, 685 F.2d 66, 69-70 (3d Cir. 1982).

24. *In re Air Crash Disaster Near Chicago*, 803 F.2d 304, 314-16 (7th Cir. 1986) (declining to follow Arizona law); *In re Air Crash Disaster Near Chicago*, 701 F.2d 1189, 1192-93 (7th Cir.), cert. denied, 464 U.S. 866, 104 S. Ct. 204 (1983) (declining to follow Illinois law). *Contra Coy v. Simpson Marine Safety Equip., Inc.* 787 F.2d 19, 26-27 (1st Cir. 1986); *Hansen v. Johns-Manville Prod. Corp.*, 734 F.2d 1036, 1045 (5th Cir. 1984).

25. See, e.g., Frolick, *supra* note 19; Harnett, *Torts and Taxes*, 27 N.Y.U. L. Rev. 614, 624-27 (1952); Henry, "Torts and Taxes, Taxes and Torts: Taxation of Personal Injury Recoveries," 23 Hous. L. Rev. 701, 723-29 (1986); Knickerbocker, *The Income Tax Treatment of Damages: A Study in the Difficulties of the Income Concept*, 47 Cornell L.Q. 429, 436-40 (1962); Yorio, *The Taxation of Damages: Tax and Non-Tax Policy Considerations*, 62 Cornell L. Rev. 701 (1977).

26. See, e.g., Burke and Friel, *Recent Developments in the Income Taxation of Individuals*, 9 Rev. Tax'n Individuals 292, 300 (1985) ("Section 104(a)(2) . . . should be limited to exclude only damages for disability, disfigurement, pain and suffering, and medical expenses. Damages for lost wages and profits should be excepted from Section 104(a)(2) and should be taxed in accord with the general rules of Section 61.");

should be taxed.<sup>27</sup> Because the courts generally have refused to allow an exclusion for compensation-based damages for nonphysical personal injuries, the economic impact of the exclusion has been diminished and the policy debate, accordingly, has been intermittent and muted. For example, Congress left section 104(a)(2) untouched by the Tax Reform Act of 1986.<sup>28</sup> As part of the Tax Reform Act, however, Congress amended section 130,<sup>29</sup> which provides favorable tax treatment for assignments of structured settlement obligations. Prior to the 1986 amendment, section 130 applied to assignments in cases involving "personal injury or sickness." For settlements entered into after December 31, 1986, however, favorable treatment under section 130 will apply only to assignments in cases "involving *physical* injury or physical sickness."<sup>30</sup> Thus, Congress has removed the category of nonphysical personal injury awards from the favorable treatment afforded by section 130 for assignments of structured settlement obligations.

A similar amendment to section 104(a)(2) in the near future is a distinct possibility. The taxpayer victories in *Threlkeld*, *Bent*, and *Metzger*, coupled with the uncertain tax consequences of punitive damages recoveries in all personal injury actions, and the imminent acknowledgment of the potential applicability of section 104(a)(2) in other categories of cases, such as "tortious breach of contract"<sup>31</sup> cases, should spark further reexamination of the confusing and inconsistent income tax aspects of our system of compensating tort victims.

Much of the confusion that reigns currently is directly traceable to application of the "in lieu of what" test, a test which ignores the necessity of interpreting the statutory terms "personal" injury and "any damages." This article will analyze the Service's approach to both terms and will suggest that the courts are correctly beginning to reject that position. Whether injuries are "personal" should be determined by reference to all the facts and circumstances, particularly the applicable state or federal law that is the basis of the plaintiff's cause of action. Inherently personal "dignitary" invasions are "personal" injuries, notwithstanding that the principal measurable impact is on the plaintiff's career or earnings. In addition, the exclusion of

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Forlick, *supra* note 19, at 567 ("[T]his Article recommends that Congress amend the section to remove the exemption for any amounts paid as compensation for lost earnings.").

27. See, e.g., Burke and Friel, *supra* note 26 at, 305 n.62 ("[P]unitive damages . . . should appropriately be viewed as something other than damages for personal injuries.").

28. Pub. L. No. 99-514, 99th Cong., 2d Sess. (1986).

29. I.R.C. § 130 (1986). For an explanation of section 130 and the recent amendment to it, see Winslow, *Tax Reform Preserves Structured Settlements*, 65 *Taxes* 22 (1987).

30. I.R.C. § 130 (1986) (emphasis added).

31. See *infra* section E of Part II.



"any damages" encompasses punitive damages. Whether the exclusion should be limited to compensatory damages for physical injuries is a decision to be made by Congress, not the Service.

## II. "PERSONAL" INJURY: CONFUSING THE INJURY WITH ITS CONSEQUENCES

Several fundamental principles govern the taxability of litigation settlements and judgments. First, any "accession to wealth, clearly realized, and over which the taxpayers have complete dominion" is "income" within the meaning of section 61(a) of the Code.<sup>32</sup> Unless there is a specific statutory exclusion available, and unless the award represents a mere recovery of capital,<sup>33</sup> the recovery must be included in the recipient's gross income. For personal injury recoveries, section 104(a)(2) is the specific statutory authorization for exclusion from income.<sup>34</sup> The tax consequences of an award thus depend on the origin and character of the claims.<sup>35</sup> If the claims are "based upon tort or tort type rights,"<sup>36</sup> then the recovery is excludable under section 104(a)(2); but if the claims are for breach of contract or injury to one's business or property, the recovery is not "on account of personal injuries" and thus not excludable under section 104(a)(2).

Taxable recoveries are generally taxed in the same manner as the items for which the recovery is intended to substitute.<sup>37</sup> The proper inquiry to determine the tax effects of damage recoveries not governed by section 104(a)(2) is "in lieu of what" were the damages awarded.<sup>38</sup> Resolution of that question determines both the amount and character of the plaintiff's income.<sup>39</sup> On the other hand, the tax consequences of personal injury recoveries should be determined by the threshold inquiry into whether the injury is personal. If the injury is personal, then "any damages" recovered "on account of" such injuries are automatically excludable under the statute, regardless of the nature of the items for which the damages are intended to substitute.

Although wages are generally fully taxable, a personal injury recovery measured solely or principally by the plaintiff's lost wages should

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32. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431, 75 S. Ct. 473, 477, reh'g denied, 349 U.S. 925, 75 S. Ct. 657 (1955).

33. See, e.g., *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir.), cert. denied, 323 U.S. 779, 65 S. Ct. 192 (1944); Rev. Rul. 81-277, 1981-2 C.B. 14.

34. I.R.C. § 104(a)(2) (1986).

35. *United States v. Gilmore*, 372 U.S. 39, 83 S. Ct. 623 (1963).

36. Treas. Regs. § 1.104-1(c) (1987).

37. See, e.g., *Raytheon*, 144 F.2d at 113.

38. *Id.*

39. E.g., *id.*; Rev. Rul. 81-277, 1981-2 C.B. 14.

be excluded from income under the broad exemption of section 104(a)(2).<sup>40</sup> Incantation of the "in lieu of what" test in personal injury cases is therefore both unnecessary and misleading. As the following analysis illustrates, erroneous application of the "in lieu of what" test in cases involving recoveries for nonphysical injuries has created significant and unwarranted barriers for victims of employment-related torts.

*A. Asking the Wrong Question: Are Personal Injury Damages "Income"?*

*1. The Early Decisions*

As has been chronicled by others,<sup>41</sup> Congress was prompted in 1918 to enact the statutory exclusion from income of personal injury damages at least in part because of doubts whether such recoveries constituted income.<sup>42</sup> Enactment of the statutory exclusion, however, did not dissuade the Service and the courts from analyzing whether a recovery was income in the first instance. Following the Supreme Court's 1920 decision in *Eisner v. Macomber*,<sup>43</sup> in which the Court endorsed its earlier definition of income as "the gain derived from capital, or from labor, or from both combined,"<sup>44</sup> the Service issued a ruling<sup>45</sup> (the "1922 Solicitor's Opinion") in which it held that recoveries for certain nonphysical personal injuries do not constitute income. The Service reasoned that:

there is no gain, and therefore no income, derived from the receipt of damages for alienation of affections or defamation of personal character. . . . If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market values, and therefor receives either damages or payment in compromise for an invasion of that right, it can not be held that he thereby derives any gain

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40. The Service recently reaffirmed this principle in the context of a physical injury. Rev. Rul. 85-97, 1985-2 C.B. 50.

41. See, e.g., *Knickerbocker*, supra note 25.

42. An unpublished ruling, T.D. 2747, and an Attorney General's Opinion issued in 1918, concluded, respectively, that amounts received as a result of a suit, or in settlement of, a personal injury claim, and proceeds of an accident insurance policy, were not subject to tax. Sol. Mem. 1384, 1920-2 C.B. 71, revoked by Sol. Op. 132, I-1 C.B. 92 (1922); see *Knickerbocker*, supra note 25, at 430.

43. 252 U.S. 189, 40 S. Ct. 189 (1920).

44. Id. at 207, 40 S. Ct. at 193.

45. Sol. Op. 132, I-1 C.B. 92 (1922), superseded by Rev. Rul. 74-77, 1974-1 C.B. 33.

or profit.<sup>46</sup>

Although this ruling's heading refers to section 213(b)(6) of the 1918 Act (the predecessor of section 104(a)(2)), the statutory exclusion is not relied upon in the ruling. Instead, the Solicitor addressed earlier rulings that had held damages for alienation of affections<sup>47</sup> and recoveries for libel<sup>48</sup> not excludable under former section 213(b)(6). The 1922 Solicitor's Opinion stated that "the question is really more fundamental, namely whether such damages are within the legal definition of income."<sup>49</sup> Relying on the definition of income in *Eisner v. Macomber*, the Solicitor found that recoveries for certain types of nonphysical personal injuries are not income in the first instance because such recoveries bear no element of gain. Significantly, the 1922 Solicitor's Opinion noted a distinction between defamation recoveries for injury to personal reputation as opposed to business reputation, but did not rule on the taxability of the latter type of recovery.<sup>50</sup>

The first reported case on the question, *Hawkins v. Commissioner*,<sup>51</sup> appeared in 1922. In *Hawkins* the taxpayer instructed his attorney to sue a corporation and its officers after he was removed from his position as president of the corporation. The threatened suit would have alleged libel and slander, with injury to his reputation, business and health. Rejecting the Service's argument that the settlement was taxable, the court held that the entire settlement received by the taxpayer was excludable because it represented "compensation for injury to his personal reputation for integrity and fair dealing, including . . . the injury to his health."<sup>52</sup> Because the tax year at issue in *Hawkins* was 1919, it is noteworthy that the court did not rely on or even mention the predecessor of section 104(a)(2), which had been enacted in 1918. Instead, consistent with the analysis of the Service at the time, the court found that the recovery did not constitute income.

Following *Hawkins*, a series of decisions permitted exclusion of business-related recoveries on the theory that the recoveries were not income because they were either a return of capital or a windfall.<sup>53</sup> For example, damages for injury to business goodwill were recognized

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46. *Id.* at 93-94.

47. Sol. Mem. 1384, 2 C.B. 71, revoked by Sol. Op. 132, I-1, C.B. 92 (1922).

48. 1 C.B. 65, modified by Sol. Op. 132, I-1, C.B. 92 (1922).

49. Sol. Op. 132, I-1 C.B. 92, 93 (1922), superseded by Rev. Rul. 74-77, 1974-1 C.B. 33.

50. *Id.*

51. 6 B.T.A. 1023 (1927), acq., 7-1 C.B. 14 (1928).

52. *Id.* at 1024.

53. See generally, *Knickerbocker*, *supra* note 25, at 433-35 (citing cases).

in 1932 as nontaxable because they represented a mere return of capital.<sup>54</sup> Such is still the case: if an injury results in damage to an asset in which the taxpayer has a basis,<sup>55</sup> the recovery is excludable from income to the extent it represents a mere return of the taxpayer's investment.<sup>56</sup> Although the return-of-capital analysis is a fundamental principle underlying the taxation of non-personal injury recoveries, it is irrelevant to the issue of excludability under section 104(a)(2). Any recovery of "damages" (including settlements) "on account of personal injuries" is excludable from gross income. Accordingly, the first and only inquiry is whether the recovery is for personal injury; if it is, then "any damages" received are excludable, regardless of whether they would otherwise constitute income in the first instance.

## 2. The "In Lieu of What" Test

In its 1944 decision in *Raytheon Production Corp. v. Commissioner*,<sup>57</sup> the First Circuit Court of Appeals articulated the test for the taxability of business injury recoveries. The *Raytheon* court, which was considering the taxability of an antitrust recovery, described the proper analysis as follows: "The test is not whether the action was one in tort or contract but rather the question to be asked is 'In lieu of what were the damages awarded?'"<sup>58</sup> Of course, the *opposite* analysis should govern any question of excludability under section 104(a)(2). In such cases, the *Raytheon* standard should be rephrased as follows: The test is whether the action is one in tort or contract. If it is an action in tort, it is irrelevant in lieu of what the damages were awarded.

Despite the inapplicability of the *Raytheon* analysis to personal injury recoveries, for more than forty years the courts have ritualistically recited the "in lieu of what" test as the governing principle.<sup>59</sup>

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54. *Farmers & Merchants' Bank v. Commissioner*, 59 F.2d 912 (6th Cir. 1932).

55. "Basis," for federal income tax purposes, is generally the taxpayer's cost or investment in the asset. I.R.C. § 1012 (1986).

56. See, e.g., Rev. Rul. 81-277, 1981-2 C.B. 14, 15 ("If . . . the recovery is treated as a replacement of capital, the damages received from the lawsuit are treated as a return of capital and are not taxable as income.").

57. 144 F.2d 110 (1st Cir. 1944).

58. *Id.* at 113.

59. For recent examples, each citing *Raytheon* and other cases, see *Thompson v. Commissioner*, 89 T.C. 632 (1987), appeal docketed, Nos. 88-3801 and 88-3924 (4th Cir. Jan. 6, 1988 and Jan. 28, 1988) (consolidated) (Title VII and Equal Pay Act recovery) ("The question to be asked is 'in lieu of what were the damages awarded.'") (citing *Fono v. Commissioner*, 79 T.C. 680 (1982), *aff'd*, 749 F.2d 37 (9th Cir. 1984)); *Church v. Commissioner*, 80 T.C. 1104, 1107 (1983) (defamation action) ("The proper inquiry is in lieu of what are the damages awarded."); *Madson v. Commissioner*, 49 T.C.M. (CCH) 425, 427 (1985) (denial of equal protection and breach of contract in

Because the courts were asking the wrong question, the results were predictably favorable to the Service in cases in which taxpayers attempted to exclude recoveries for employment-related injuries. If the recovery appeared to be "in lieu of" wages, earnings, severance pay or some other element of the recipient's compensation, then the recovery was held taxable.

The flaw in this analysis is patent: if the injury that is being compensated is a "personal" injury, then all damages received "on account of" it are excludable under section 104(a)(2), *including* damages for lost earnings. If the recovery represents damages for breach of contract or any other non-tort or tort-type injury, then the damages are fully taxable, unless they merely restore a taxpayer's basis. Thus, the threshold inquiry should always be into the nature of the claim or injury, and the presence or absence of a discernible link between the recovery and the recipient's compensation arrangement should be irrelevant. Especially in employment-related cases, application of the "in lieu of what" test has skewed the analysis and led to unfair results.

A footnote in a famous Supreme Court decision has compounded the confusion. In 1955 the Supreme Court refined its earlier definition of "income" to include windfall recoveries. In *Glenshaw Glass Co. v. Commissioner*,<sup>60</sup> the Court held that punitive damages recovered in business fraud and antitrust cases were income. Denying that its earlier definition of income in *Eisner v. Macomber*<sup>61</sup> was "meant to provide a touchstone to all future gross income questions," the Court established a definition of income broad enough to encompass such items as windfalls and discovery of treasure trove.<sup>62</sup> In a footnote the Court in *Glenshaw Glass* also distinguished the recoveries at issue from personal injury recoveries. Apparently approving the early rulings that held personal injury recoveries to be a nontaxable return of capital, the Court observed that these rulings "cannot support exemption of punitive damages following injury to property."<sup>63</sup> As discussed in Part III, *infra*, this footnote has become the cornerstone of the Service's current position that punitive damages in personal injury cases are taxable because they are not a restoration of capital. By appearing to

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terminating unemployment) ("The relevant inquiry is, 'In lieu of what were the damages awarded?'""); *Fono v. Commissioner*, 79 T.C. 680 (1982), *aff'd*, 749 F.2d 37 (9th Cir. 1984) (settlement involving alleged mental distress recovery) ("The question to be asked is: 'In lieu of what were the damages awarded?'"")

60. 348 U.S. 426, 75 S. Ct. 473, *reh'g denied*, 349 U.S. 925, 75 S. Ct. 657 (1955).

61. 252 U.S. 189, 40 S. Ct. 189 (1920).

62. Shortly after the *Glenshaw Glass* decision, the Treasury Department promulgated regulations under section 61 enumerating miscellaneous categories of receipts that constitute income. *Treas. Reg. § 1.61-14* (1987).

63. 348 U.S. at 431 n.8, 75 S. Ct. at 477 n.8.

endorse the return of capital analysis for compensatory personal injury recoveries, this footnote also encouraged the return of capital analysis in section 104(a)(2) cases.

On the other hand, taxpayers may not rely on the return of capital analysis to justify exclusion of payments in exchange for bodily parts or products. Nor may advance payments for future invasions of privacy be excluded under section 104(a)(2).<sup>64</sup> The Service summarily rejected the return of capital analysis in *United States v. Garber*,<sup>65</sup> a case involving the sale of rare blood plasma. The taxpayer in *Garber* was prosecuted for willful evasion of income taxes because she excluded from income the substantial payments she received for her plasma. The trial judge refused to admit into evidence the testimony of an expert defense witness that the taxpayer's receipts did not constitute income, but instead were a nontaxable recovery of her basis in her blood. The government's expert witness, however, was permitted to testify that the taxpayer's receipts constituted taxable income, on the theory that the plasma donations were personal services, not the sale of a product.<sup>66</sup> Another expert witness for the government, whose testimony was excluded, opined that if the transaction was a sale of a product rather than a service, it would still be taxable because "there would be no tax basis or original cost for the product sold, and the entire sales price would constitute gain subject to tax under section 61(a)(3)."<sup>67</sup>

This curious case suggests that the Service's view of the taxpayer's basis in his body depends on the context in which the issue arises. If one sells part of one's body (e.g., blood or an organ), then the Service apparently will assign a basis of zero to the bodily part, with the result being that the entire payment received is taxable. On the other hand, individuals who recover damages for physical personal injuries will receive the benefit of a deemed basis in their injured bodily part equal to the damages received, and thus will escape taxation because the recovery is a mere return of capital.<sup>68</sup>

Thus, application of two related but superfluous tests has thoroughly skewed the analysis and results in employment-related non-physical personal injury cases. The return of capital analysis, unnec-

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64. See, e.g., *Starrels v. Commissioner*, 304 F.2d 574 (9th Cir. 1962), aff'g, 35 T.C. 646 (1961). See *infra* Part III for a discussion of *Starrels*.

65. 607 F.2d 92 (5th Cir. 1979) (rehearing en banc rev'g 589 F.2d 843).

66. *Id.* at 95-96.

67. *Id.* at 95.

68. See generally, Stephan, *Taxation and Human Capital*, 70 Va. L. Rev. 1357 (1984).

essarily applied by the Service and the courts despite the specific statutory exclusion, led the courts to conclude that certain recoveries did not constitute income in the first instance. That same analysis, however, led to the uncritical importation of the "in lieu of what" test into section 104(a)(2) jurisprudence, with the predictable (but incorrect) result that damages tied to or measured by an otherwise taxable item, such as salary or earnings, almost always have been held not excludable.

The continuing allure of the "in lieu of what" analysis is evident in a recent Supreme Court decision<sup>69</sup> concerning the Federal Aid to Families with Dependent Children (AFDC) program.<sup>70</sup> The issue was whether a state could consider personal injury recoveries as income in determining need for purposes of the AFDC program. In a five to four decision, both the majority and dissent agreed, in dicta, on the principle that personal injury damages for lost earnings, under the Code, were income. The majority stated:

[T]he premise that personal injury awards cannot involve gain is obviously false, since they often are intended in significant part to compensate for the loss of gain, e.g., lost wages. Since the gain would have been income, surely at least that part of a personal injury award that replaces it must also be income.<sup>71</sup>

The dissenters conceded this point. After noting that it would be unlikely that "an impoverished family" would receive a large personal injury award for lost income, the dissenters reasoned as follows:

If it does, however, it is reasonable to treat such an award as income. I cannot agree, however, that it is reasonable to treat the entire personal injury award as income. Damages for pain and suffering, disfigurement, loss of consortium, and the like are intended to compensate the recipient for nonpecuniary losses.<sup>72</sup>

Although section 104(a)(2) was not an issue directly before the Court, and therefore the issue of excludability of amounts that would otherwise be taxable income was not before the Court, this dicta is a sobering reminder of the long-standing antipathy to taxpayers' attempts to exclude recoveries representing lost earnings from income.

#### *B. Allocated versus Lump-Sum Recoveries*

Because neither section 104(a)(2) of the Code nor the regulations under it describe how one establishes that damages were received "on

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69. *Lukhard v. Reed*, 107 S. Ct. 1807 (1987).

70. 42 U.S.C.A. §§ 601-615 (1983 & Supp. 1987).

71. 107 S. Ct. at 1811.

72. *Id.* at 1819 (Powell, J., dissenting).

account of personal injuries," and because section 104(a)(2) is an exception to the general rule of taxability of damages, the courts have required the taxpayer to establish that any recovery excluded from income is, in fact, on account of personal injuries. Methods of proof differ, of course, depending on whether the recovery is in settlement of an actual or threatened action or is court-ordered.

### 1. Jury Awards

Unallocated jury awards in cases where past and future medical expenses formed part of plaintiff's evidence of damages present two problems. First, any portion of the award allocated to past medical expenses must be included in income under the express terms of section 104(a)(2). As to future medical expenses, section 213 prohibits future medical expense deductions to the extent that the taxpayer has already been compensated for the expense "by insurance or otherwise." Thus, amounts actually allocated by the jury to future medical expenses will not support a deduction until the future expenses exceed the damages allocated to future medical expenses.<sup>73</sup>

If the plaintiff's award is not allocated between specified past and future medical expenses, the Service will require the plaintiff to allocate a portion of the award to future medical expenses and forego future medical expense deductions until the future expenses exceed the amount as allocated.<sup>74</sup> In the only reported decision considering allocation of a lump-sum jury award to future medical expenses, the Ninth Circuit refused to uphold an allocation by the Service of part of the award to nondeductible future medical expenses. In *Niles v. United States*,<sup>75</sup> the court held that the Service had the burden of establishing the amount that the jury intended as compensation for future medical expenses, and that such burden could not be discharged because only the jury could know what it intended. Thus, the plaintiff may benefit twice from an unallocated and unallocable award that is intended to compensate for future medical expense: the recovery is excludable from income in the first instance, and the later expenditures for medical expenses are deductible.<sup>76</sup>

### 2. Out-of-court Settlements

As to out-of-court settlements, both the statute itself and the regulations specify that the exclusion of "any damages" includes amounts

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73. I.R.C. § 213 (1986); see Rev. Rul. 75-323, 1975-2 C.B. 346.

74. Rev. Rul. 79-427, 1979-2 C.B. 120.

75. 710 F.2d 1391 (9th Cir. 1983).

76. For criticism of this decision, see Note, *Niles v. United States*: Double Tax Benefits Arise From the Ninth Circuit's Questionable Interpretation of Section 213, 4 Va. Tax Rev. 427 (1985).



received in settlement of personal injury or sickness claims.<sup>77</sup> Two significant problems confront a person wishing to exclude settlement recoveries. First, in cases involving business-related nonphysical injuries, unless there is a settlement agreement that specifically designates part or all of the award to personal injury claims, the Service will treat the entire recovery as taxable. In addition, the recent administrative ruling<sup>78</sup> that punitive damages received in a personal injury action are taxable has magnified the importance of a specific allocation between compensatory and punitive damages in the settlement agreement. The Service's current position is that if both compensatory and punitive damages were sought in the complaint, any settlement must be allocated between the taxable (punitive) portion and the compensatory (nontaxable) component based on the best available evidence of proper allocation, which (absent an allocation in a settlement agreement) will be the prayer for relief in the complaint.<sup>79</sup> Thus, if the complaint sought \$10,000 in compensatory damages for a physical personal injury and \$90,000 in punitive damages, and if the parties settle for \$10,000 only \$1,000 of that amount will be excludable from income unless there is some better evidence than the complaint as to the allocation the parties desired.<sup>80</sup>

*a. Employment-related nonphysical injury settlements*

Most of the reported decisions concerning the taxability of employment-related awards involve settlement agreements. To justify an exclusion of all or part of such an award, a taxpayer must establish both that his actual or threatened claims involved a personal injury

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77. I.R.C. § 104(a)(2) (1986); Treas. Regs. § 1-104-1(c) (1987).

78. Rev. Rul. 84-108, 1984-2 C.B. 32.

79. Rev. Rul. 85-98, 1985-2 C.B. 51.

80. Although precedent indicates that the parties' allocation will be respected, caution would dictate that amendment of the complaint to decrease or delete the prayer for punitive damages, followed by a settlement that is silent as to allocation, should be avoided as an invitation to the Service to disregard the amendment. But cf. 28 Trial Law. Guide 309, 310 (1984):

It is suggested that in regard to settlement, counsel withdraw any claim for punitive damages before entering into settlement, or state in the quittance papers that no part of the settlement is in payment of punitive damages. It is unlikely that the government would check every settlement of every personal injury or wrongful death case and in many cases, where both compensatory and punitive damages are claimed, settlements are made routinely solely on the basis of payment of compensatory damages. If in fact an allowance for punitive damages is not a consideration for settlement, it would seem that the Government should not be permitted to tax any portion of the settlement funds, even though claims were alleged for both punitive and compensatory damages.

claim, and that part or all of the settlement represents settlement of the personal injury claim. As to the first inquiry concerning the existence of a personal injury claim, the validity of the claim is irrelevant.<sup>81</sup> Assuming that the taxpayer can establish the existence of a personal injury claim, he must then establish that the payment received was in fact in settlement of such claim. An express allocation in the settlement agreement of part or all of the recovery to settlement of the personal injury claim apparently will suffice.<sup>82</sup> On the other hand, a carefully negotiated settlement agreement that allocates no part of the award to settlement of personal injury claims has been held to preclude exclusion from income, even though the agreement was later amended to allocate retroactively part of the settlement to personal injury claims.<sup>83</sup>

Rarely does the taxpayer prevail in excluding part of an unallocated employment-related settlement from income. The immensity of the taxpayer's burden is exemplified by *Seay v. Commissioner*,<sup>84</sup> one of the few taxpayer victories, and one that provokes skepticism as to whether any amount of attorney diligence that falls short of an allocation in a document labeled "settlement agreement" could ever ensure exclusion under section 104(a)(2). In *Seay* the taxpayer recovered \$105,000 in settlement of his claims for breach of contract and personal injuries (embarrassment and harm to personal reputation) arising out of the termination of his employment. Negotiators representing Seay and his former employer signed a letter memorializing the settlement and allocating \$45,000 of the \$105,000 settlement to Seay's personal injury claim.<sup>85</sup> Three years after the settlement letter was signed, the general manager of Seay's former employer signed a letter stating that the nature of the \$45,000 payment was correctly designated in the original settlement letter.<sup>86</sup>

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81. *Seay v. Commissioner*, 58 T.C. 32, 37 (1972) ("[W]e hold that the determination of whether a settlement payment is exempt from taxation depends on the nature of the claim settled and not on the validity of the claim.").

82. No direct authority exists, but numerous courts have found the absence of an express allocation to permit or require analysis by the court of other factors. See, e.g., *Villaume v. United States*, 616 F. Supp. 185 (D. Minn. 1985) (no allocation in settlement agreement; entire recovery held taxable as replacement for compensation); *Glynn v. Commissioner*, 76 T.C. 116 (1981), aff'd, 676 F.2d 682 (1st Cir. 1982) (unallocated settlement held to represent recovery of accrued sick leave).

83. *Fono v. Commissioner*, 79 T.C. 680 (1982), aff'd, 749 F.2d 37 (9th Cir. 1984).

84. 58 T.C. 32 (1972).

85. The "letter clearly designated the \$45,000 payment 'as compensation for such personal embarrassment, mental and physical strain and injury to health and personal reputation in the community' as the petitioner had suffered." 58 T.C. at 38.

86. *Id.*

Nonetheless, the Service assessed a deficiency, claiming that no part of the settlement was excludable as a personal injury recovery. The Tax Court disagreed, finding that the taxpayer had discharged his duty of establishing that the \$45,000 amount was received "on account of personal injuries":

Under these circumstances, where the chief negotiator for each party has testified that the payment was for personal injuries and where there is a letter which has been acquiesced in by the parties and which states that the payment was for personal injuries, the petitioner has successfully established that the nature of the claim was for personal settlement of such claim.<sup>87</sup>

Absent an express allocation in a settlement agreement treated as such by the Service,<sup>88</sup> "the most important fact in determining how section 104(a)(2) is to be applied is 'the intent of the payor' as to the purpose in making the payment." The opinion of the Second Circuit Court of Appeals affirming the Tax Court's decision in *Agar v. Commissioner*<sup>90</sup> appears to be the origin of the "intent of the payor" test. Agar, a certified public accountant, had served as a corporation's accountant and treasurer for twelve years. As his retirement approached,<sup>91</sup> the corporation hired another accountant and appointed Agar to a five-year term as treasurer. He was also made a director of the corporation. Shortly thereafter Agar found that the corporation "had lost confidence in him."<sup>92</sup> Claiming humiliation and damage to his health, Agar threatened suit. The corporation settled, agreeing to pay Agar \$45,000 in three equal annual installments. He excluded these payments from his gross income, explaining on his return that the recovery was tax-exempt because it was in settlement of a libel claim.<sup>93</sup>

The Commissioner disallowed the exclusion, and the Tax Court upheld the Commissioner on two grounds:

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87. *Id.*

88. As *Seay* demonstrates, a document signed by both parties to the settlement negotiations that expressly allocates the payments to designated claims may not be respected by the Service.

89. *Bent v. Commissioner*, 87 T.C. 236, 245 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987) (citing *Knuckles v. Commissioner*, 349 F.2d 610 (10th Cir. 1965)); *Fono v. Commissioner*, 79 T.C. 680, 694 (1982), *aff'd*, 749 F.2d 37 (9th Cir. 1984); *Glynn v. Commissioner*, 76 T.C. 116, 120 (1981), *aff'd*, 676 F.2d 682 (1st Cir. 1982).

90. 290 F.2d 283 (2d Cir. 1961) (*aff'g* 19 T.C.M. (CCH) 116 (1960)).

91. Surprisingly, the record does not reflect Agar's precise age at the time of his "demotion." The Second Circuit's opinion states that it occurred when he was "63 or 64." *Id.*

92. *Id.*

93. *Id.* at 284.

first, that the payments were in the nature of severance pay or extra compensation and not in settlement of a possible tort claim; the gravamen of that claim was an injury to business reputation and thus the taxpayer could not rely on the statutory exemption of payments on account of "personal injuries."<sup>94</sup>

The Second Circuit affirmed on the first ground, that the payments were actually extra compensation, and therefore did not reach the business-reputation versus personal-reputation theory. The court did, however, question whether the latter "dichotomy is realistic."<sup>95</sup> The court found that Mr. Agar's belief that the payment was in settlement of a libel claim was merely "evidence" of the actual nature of the payment. The "ultimate inquiry," it asserted, was "into the 'basic reason' for the company's payment."<sup>96</sup> Based on the testimony of the corporation's president that the payments were for "severance," the Second Circuit affirmed the Tax Court's decision in favor of the Commissioner, notwithstanding that the president did not participate in the negotiations, that the testimony of the corporation's negotiator (a lawyer) was not available, and that Mr. Agar firmly believed the payments were in settlement of his libel claim.<sup>97</sup>

#### *b. General Releases*

Many, if not most, settlements of employment-related disputes involve the employee's execution of a general release in exchange for an agreed-upon monetary payment from the employer. Boilerplate language in the release typically specifies that the release is in settlement of any and all claims, action or causes of action, in law or in equity, contract or tort. Until the April 1987 decision of the Tax Court in *Metzger v. Commissioner*,<sup>98</sup> discussed in part II E *infra*, in every reported decision involving a settlement agreement containing such a general release, the employee had been denied an exclusion under section 104(a)(2) for any portion of the settlement.

A series of cases involving the termination of employment of professors at Southern Illinois University typifies the generally unresponsive attitude of the courts toward any exclusion from income of

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94. *Id.*

95. *Id.*; see generally *infra* Part C.

96. *Id.*

97. After the settlement was reached, but before the ensuing tax litigation, the corporation's lawyer died. The Second Circuit appropriately noted that this was "unfortunate" for Agar because the lawyer was certainly the individual who was most familiar with Agar's threatened suit and the reasons for the corporation's payments. *Id.*

98. 88 T.C. 834 (1987), appeal docketed, No. 87-1428 (3d Cir., July 16, 1987).

such recoveries. In 1973 the Illinois Board of Higher Education adopted a budget for Southern Illinois University at Carbondale (SIUC) that required a significant reduction in teaching staff. Both tenured and non-tenured professors were terminated and SIUC negotiated settlements with the terminated individuals. A number of the terminated professors excluded the settlements from income, and four Tax Court memorandum decisions<sup>99</sup> ensued, each of which concluded that the general releases<sup>100</sup> signed by the individuals did not support any exclusion from income. Despite evidence of humiliation and damage to reputation,<sup>101</sup> the courts found that the nature of the claim settled in each case was essentially contractual, and that the parties' failure to allocate any portion of the settlement to potential tort claims was fatal to the taxpayers' position. Each court found it significant that the settlement award approximated one year's salary; therefore, the courts reasoned, that the payments were intended as additional compensation "to forestall an action for breach of contract."<sup>102</sup>

The broad language of the releases, encompassing both tort and contract claims, was found by one of the courts to be "a matter of form rather than basic intent."<sup>103</sup> Another court admitted that the reference to tort claims in the release is completely ineffective for tax

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99. *Whitehead v. Commissioner*, 41 T.C.M. (CCH) 365 (1980), aff'd in unpublished opinion (10th Cir. Nov. 20, 1981); *Evans v. Commissioner*, 40 T.C.M. (CCH) 260 (1980); *Anderson v. Commissioner*, 38 T.C.M. (CCH) 1206 (1979); *Gunderson v. Commissioner*, 38 T.C.M. (CCH) 464 (1979).

100. The releases were substantially identical. Each contained the following language:

I . . . in consideration of the payment of the sum of . . . have remised, released and forever discharged, and by these presents do, for myself and for my heirs, executors, administrators, and assigns, hereby release, remise, and forever discharge the Board of Trustees of Southern Illinois University, its agents, employees, successors, and assigns, of and from any and all manner of action or actions, either in law or in equity, contract, tort, or otherwise, which the undersigned might now have against the Board of Trustees . . . , and more particularly the claims or demands arising out of the employment or the lack thereof, as . . . Professor in the Department of . . . .

Said release is in settlement of any and all claims arising out of the employment or lack thereof of . . . . It is understood and agreed that this settlement is the compromising of a disputed claim, and that the payment or any other agreements contained herein shall not be construed as an admission of liability.

*Whitehead*, 41 T.C.M. (CCH) at 367; *Evans*, 40 T.C.M. (CCH) at 262; *Anderson*, 38 T.C.M. (CCH) at 1207; *Gunderson*, 38 T.C.M. (CCH) at 464-65.

101. See, e.g., *Anderson*, 38 T.C.M. (CCH) at 1208 ("When the names of those who were being terminated became public, they were . . . ostracized . . . their reputations were lowered . . . and many of them found difficulty finding other employment at the same level.").

102. *Anderson*, 38 T.C.M. (CCH) at 1208.

103. *Id.* at 1209.

purposes absent a specific allocation in the agreement: "Even if petitioner had established . . . that the university regarded a portion of the settlement as payment for tort or tort-type damages suffered by petitioner, we would be compelled to reach the same result because no allocation of the lump-sum payment was made."<sup>104</sup>

This remarkable statement appears in the same opinion that dutifully recites that "[t]he most important fact in making the determination of the nature of the claim settled is the intent of the payor in making the settlement payment."<sup>105</sup> The rule enunciated by this court is simply that intent of the payor is determinative, but even if the taxpayer succeeds in establishing that the payor's intent is to compensate for a tort claim, the recovery must be included in income if the settlement agreement contains no specific allocation. Although this case may be only a slip of the judicial pen, it demonstrates the near impossibility of establishing the propriety of excluding from income an unallocated settlement of an employment-related dispute.<sup>106</sup>

### *C. Defamation Actions: Business Reputation versus Personal Reputation*

Most of the employment-related cases dealing with section 104(a)(2) involve threatened or actual defamation claims by the taxpayer. Because the Service has long maintained, and the courts have generally ruled, that damages for injury to one's business or professional reputation are not excludable under section 104(a)(2), individuals who recovered damages for business-related nonphysical injuries such as defamation or malicious prosecution have been forced to establish that their exclusion of the award from income is proper. The principal difficulty has been in the oft-repeated distinction between "personal" reputation and "business" reputation: if the injury appears to have been prin-

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104. *Whitehead*, 41 T.C.M. (CCH) at 369 (footnote omitted).

105. *Id.* at 368.

106. Additional examples include *Madson v. Commissioner*, 49 T.C.M. (CCH) 425 (1985) (settlement during appeal of judgment in taxpayer's favor in suit for denial of equal protection and breach of contract; summary judgment for taxpayer inappropriate because settlement agreement silent on allocation; notation of "Bodily Injury" on settlement check inefficient); *Nussbaum v. Commissioner*, 45 T.C.M. (CCH) 346, 348 (1982) (None of unallocated settlement of claims arising from termination of taxpayer's employment excludable; general release of "all claims" not probative of payor's intent because "[w]e think it highly unlikely that an organization such as the *Times* would sign a document in part settling a suit for mental anguish without, protectively, stating so specifically."); *Glynn v. Commissioner*, 76 T.C. 116, 121 (1981), *aff'd* in unpublished opinion (1st Cir. 1982) (unallocated settlement arising out of termination of employment held to be "essentially severance pay," despite reference in agreement to damaged reputation).

cipally to one's business reputation, then the recovery is merely a substitute for lost income and is taxable. Especially prior to the 1984 ruling<sup>107</sup> that punitive damages in personal injury actions are not excludable under section 104(a)(2), the stakes in such cases would be quite substantial. If the individual recovered both compensatory and punitive damages, then the entire award would be tax-free if the injury was found to be personal; if the injury was held to be to one's "business" reputation, then both the compensatory and punitive damages would be fully taxable.

The travails of Paul F. Roemer, a California insurance salesman, and Wade E. Church, then the Arizona Attorney General, dramatically illustrate the tax impact of the varying definitions of "any damages" and "personal" injury. Both men recovered substantial damage awards (both punitive and compensatory) in defamation actions, both excluded their recoveries from income, and both defended their exclusion in litigation in the United States Tax Court. The Tax Court decided in *Roemer v. Commissioner*<sup>108</sup> that Mr. Roemer's injury was not personal, and thus that his entire recovery was taxable. Less than ten months later, however, the Tax Court ruled that Mr. Church properly excluded his entire recovery from income.<sup>109</sup> Shortly after the *Church* decision, the Ninth Circuit Court of Appeals reversed the Tax Court's decision in *Roemer*. The Service then issued a ruling<sup>110</sup> stating that it would follow the Tax Court opinion in *Roemer*, and not the Ninth Circuit's analysis. In *Threlkeld v. Commissioner*,<sup>111</sup> the Tax Court rejected its own earlier approach and announced that it will follow the Ninth Circuit's analysis. The Service has not revoked its ruling, and thus it continues to follow and apply the analysis of the Tax Court in *Roemer*, notwithstanding that the Tax Court itself has disavowed that analysis. The *Threlkeld* decision and its effects are discussed in Part 2, *infra*.

### I. Roemer and Church

In 1965, Paul Roemer, an independent insurance broker who primarily sold casualty insurance, applied for an agency license to sell life insurance. As part of the review of his license application, the insurance company obtained a credit report on Roemer. The report was "grossly defamatory,"<sup>112</sup> and stated, among other things, that Roemer neglected his clients' affairs, was ignorant in insurance matters,

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107. Rev. Rul. 84-108, 1984-2 C.B. 32.

108. 79 T.C. 398 (1982), rev'd, 716 F.2d 693 (9th Cir. 1983).

109. *Church v. Commissioner*, 80 T.C. 1104 (1983).

110. Rev. Rul. 85-143, 1985-2 C.B. 55.

111. 87 T.C. 1294 (1986), appeal docketed, No. 87-1511 (6th Cir., May 26, 1987).

112. *Roemer*, 79 T.C. at 400.

intentionally damaged others' property, and had been fired from his position as president of an insurance firm. The report also implied that Mr. Roemer had misappropriated funds belonging to others.

Roemer learned of the defamatory credit report and demanded its retraction. The issuer of the report then distributed a purported retraction, in which it further defamed Roemer and questioned his integrity. Mr. Roemer was denied the agency license and his business suffered because of the damage to his reputation and the fact that "most of his friends were also his clients, and vice versa."<sup>113</sup>

Roemer sued the issuer of the credit report, alleging that the report had damaged his reputation as an insurance broker and had caused him to lose business and profits. At trial, Roemer produced evidence of his "exemplary background" and good reputation in the insurance industry. The jury awarded Roemer \$40,000 in compensatory damages and \$250,000 in punitive damages. Roemer excluded the recovery from his income,<sup>114</sup> but the Service assessed a deficiency, finding that Roemer should have included the entire award in his income.

If the defamation were characterized as a personal injury, then Roemer properly excluded from income both the compensatory award and the punitive damages, since the Service's position at that time was that punitive damages received on account of personal injury are excludable.<sup>115</sup> On the other hand, if the injury was not personal, then none of the damages could be excluded under section 104(a)(2). Depending on the nature of the injury, therefore, Roemer's recovery of \$290,000 was either fully taxable or completely excludable from his income.

The Tax Court, in a reviewed<sup>116</sup> decision, concluded that the compensatory damages were fully taxable because, based on the pleadings and testimony at trial, "the predominant nature of his claims involved damages to his business and professional reputation as an insurance broker."<sup>117</sup> Having concluded that the \$40,000 of compensatory damages were not awarded for a personal injury, the Tax Court found the punitive damages similarly includable in income because they were not awarded on account of a personal injury.

Two dissenting opinions were filed. Judge Forester's opinion, in which Judge Korner joined, stated that the test for excludability should

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113. *Id.*

114. Actually he reported part of the recovery as income, but took the position in the Tax Court litigation that none of the damage recovery should have been included in income. *Id.* at 403-04.

115. See *infra* Part III.

116. For an explanation of "reviewed" Tax Court decisions, see *supra* note 10.

117. *Roemer*, 79 T.C. at 406.



be whether there has been injury to reputation or only injury to occupation. One's reputation is personal, according to Judge Forester, and any damage to it is a personal injury. Even if the manifestation of the injury occurs primarily in the individual's occupation, this cannot alter the personal nature of the injury.<sup>118</sup> On the other hand, an injury solely to one's occupation or profession that does not injure one's reputation is not a personal injury. Applying this test, Judge Forester found the injury Roemer complained of was to his reputation, and therefore the damages were properly excluded under section 104(a)(2).

Judge Wilbur also dissented, agreeing with Judge Forester that the majority erroneously confused Roemer's proof of his damages with the nature of his injury. Judge Wilbur's opinion noted that lost wages and diminished earning capacity are almost always used to measure the damages caused by personal injuries. Nonetheless, Judge Wilbur stated, the majority's decision will compel "the bifurcation of a defamation action into categories corresponding to components of damages,"<sup>119</sup> and plaintiffs will be taxed on their recoveries only if their damages are readily measurable in economic terms.

The Ninth Circuit reversed the Tax Court's decision in *Roemer*.<sup>120</sup> It rejected the Tax Court's reliance on the pleadings and testimony, and instead found that state law should determine the characterization of an injury as personal or nonpersonal. Based upon its thorough review of the history of defamation, at common law and in the California codification, the Ninth Circuit concluded that defamation is a personal injury, and that compensatory damages recovered were therefore excludable under section 104(a)(2).

The court noted the existence of a separate cause of action for nonpersonal attacks on the quality of one's goods or services. A plaintiff may have a cause of action for defamation (a personal injury), or for one of the related torts of trade libel and product disparagement. Observing that it "is sometimes difficult to draw the line between disparagement and defamation,"<sup>121</sup> the court nonetheless concluded that an individual<sup>122</sup> who recovers damages in a defamation action may exclude the recovery under section 104(a)(2).

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118. *Id.* at 411-12 (Forrester, J., dissenting).

119. *Id.* at 414 (Wilbur, J., dissenting).

120. *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983).

121. *Id.* at 699.

122. In a footnote, the court acknowledged that corporations may sue for some types of defamation. Availability of this cause of action to corporations did not, in the court's view, render it a nonpersonal action, even though corporations cannot suffer "personal" injury. See *id.* at 699 n.4.

Like the dissenting judges in the Tax Court, the Ninth Circuit correctly focused on the distinction between the nature of the injury itself and not the proof of damages caused by the injury:

[A]ll defamatory statements attack an individual's good name. This injury to the person should not be confused with the derivative consequences of the defamatory attack, *i.e.*, the loss of reputation in the community and any resulting loss of income. *The nonpersonal consequences of a personal injury, such as loss of future income, are often the most persuasive means of proving the extent of the injury that was suffered. The personal nature of an injury should not be defined by its effect.*<sup>123</sup>

Having rejected the Tax Court's analysis and determined that the compensatory damages recovered by Roemer were excludable because defamation is a personal injury under California law, the Ninth Circuit found the punitive portion of his award excludable under Revenue Ruling 75-45.<sup>124</sup>

Just less than ten months after its decision in *Roemer*, and two months before the Ninth Circuit's reversal of *Roemer*, the Tax Court handed down its decision in *Church v. Commissioner*.<sup>125</sup> Church had recovered \$250,000 compensatory and \$235,000 punitive damages from a newspaper that had falsely accused him of being a Communist. Church excluded the recovery from income, and the Service assessed a deficiency, claiming that the entire recovery was taxable.

Applying the analytical approach it had formulated in *Roemer*, the Tax Court stated that "[t]o ascertain the nature of the damages, it is necessary in this case to examine the allegations contained in petitioner's original and amended complaints, the evidence presented, and the arguments made in the State court proceeding."<sup>126</sup> Under this analysis, the Tax Court concluded that *Roemer* was "clearly distinguishable" because, unlike in *Roemer*, "the entire thrust of Church's case was how the libelous editorial affected him personally."<sup>127</sup>

In its eagerness to distinguish *Roemer*, the court candidly but erroneously stated that courts "have consistently held that amounts received in lieu of wages, salary, or lost profits are includable in income."<sup>128</sup> Of course, if the injury is personal, damages for lost income

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123. Id. at 699 (emphasis added).

124. Rev. Rul. 75-45, 1975-1 C.B. 47.

125. 80 T.C. 1104 (1983).

126. Id. at 1107.

127. Id.

128. Id.

or profits should be fully excludable under section 104(a)(2).<sup>129</sup> The Service insisted that *Roemer* was not distinguishable, since the Tax Court's own test required an analysis of the economic impact of the injury to determine whether it was personal. Clearly, according to the Service, the damage to a state Attorney General who is accused of being a Communist is no more or less personal than the damage to an insurance broker who is reported to be dishonest and incompetent. Perhaps foreshadowing its abandonment of its analysis in *Roemer*, the Tax Court found that the Service had applied the *Roemer* "test much too broadly,"<sup>130</sup> and reasoned as follows:

It is simply not enough that the injury arose in connection with the taxpayer's business or his professional endeavor, or that the injury is somehow remotely "capable" of affecting his income. Even though the editorial destroyed petitioner's career as a public servant and it marked the end of a promising political career, it did not take away his career as an attorney. Moreover, to the extent petitioner's professional reputation was damaged, we find no basis for distinguishing between that injury and the mental distress, pain, and suffering that flowed therefrom. That he was a public figure simply compounded the pain. *In our opinion, shattered dreams, ruined careers, and the mental anguish that follow are just as personal as, for instance, loss of limb.*<sup>131</sup>

*Roemer* and his attorney certainly must have been stunned. *Roemer's* use of readily available evidence of measurable economic damages, which apparently *Church* did not have, was the only meaningful distinction between the two cases. Rather than abandoning the *Roemer* analysis, however, the Tax Court defended it and claimed to have applied it, with the result that two individuals who suffered almost identical injuries were subject to polar opposite income tax treatment, with the only difference being the methods of pleading and proving damages.

The *Roemer* and *Church* decisions prompted several administrative rulings on the taxation of personal injury recoveries and exacerbated the confusion concerning the meaning of a "personal" injury under section 104(a)(2) of the Code. The first administrative ruling involved the excludability of punitive damages in personal injury actions. In Revenue Ruling 84-108,<sup>132</sup> the Service declared that damages charac-

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129. Rev. Rul. 85-97, 1985-2 C.B. 50 (damages for lost earnings excludable).

130. *Church*, 80 T.C. at 1109 (emphasis added).

131. *Id.*

132. Rev. Rul. 84-108, 1984-2 C.B. 32.

terized under state law as punitive were includable in income. Part III of this article analyzes this issue.

The Service also rejected the Ninth Circuit's analysis in *Roemer* and espoused the Tax Court's approach to the determination of whether an injury is personal. In Revenue Ruling 85-143,<sup>133</sup> the Service stated that the characterization of the nature of the injury under state law is not determinative. Instead, whether a defamatory statement caused a personal injury is to be determined by "the thrust of the petitioner's case."<sup>134</sup> If "the main thrust of the evidence" is "of lost business income," the Service stated, the injury is not a personal injury, regardless of state law, and all damages recovered are fully taxable.<sup>135</sup> Thus, although state law characterization of damage recoveries as punitive in nature will now result in automatic taxation of such recoveries under Revenue Ruling 84-108, the state law characterization of the nature of the injury itself is irrelevant, according to the Service. Instead, the party's pleadings and proof will control the taxability of his recovery.

## 2. *Threlkeld v. Commissioner: An About-Face*

On December 8, 1986 the Tax Court issued its reviewed opinion in *Threlkeld v. Commissioner*<sup>136</sup> in which the court, after reviewing precedents from the 1922 Solicitor's Opinion<sup>137</sup> up to and including the Ninth Circuit's decision in *Roemer*, declared that the Ninth Circuit's approach is correct. Henceforth, according to the court,

the approach that we will now apply in all cases, whether [*sic*-where] the injury claimed is personal, more accurately reflects the inquiry required by the plain meaning of the statute. Exclusion under section 104 will be appropriate if compensatory damages are received on account of any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law.<sup>138</sup>

Although the court acknowledged only that it was denying the validity of distinguishing between "business" reputation and "personal" reputation, its holding implicitly overrides decades of precedent in which the courts have determined the nature of the injury by inquiring into whether the damages were a substitute for lost income.

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133. Rev. Rul. 85-143, 1985-2 C.B. 55.

134. *Id.*

135. *Id.*

136. 87 T.C. 1294 (1986) appeal docketed, No. 87-1511 (6th Cir., May 26, 1987).

137. Sol. Op. 132, I-1 C.B. 92. See *supra* text accompanying notes 45-49.

138. *Threlkeld*, 87 T.C. at 1308.

At issue in *Threlkeld* was the excludability of a pre-trial settlement of a suit for malicious prosecution. Threlkeld's complaint sought compensatory damages of \$250,000 and punitive damages of \$1,000,000. Prior to trial, the parties entered into a settlement agreement pursuant to which they settled the malicious prosecution suit and Threlkeld released the other party from all other pending claims. Threlkeld was to receive \$300,000 in settlement, \$75,000 of which was allocated to compensate for damage to his professional reputation. In 1980, the tax year in question, Threlkeld received \$86,000 of the total settlement, of which \$21,500 represented payment for injury to his professional reputation. Threlkeld excluded this portion of the recovery from income, and the Commissioner assessed a deficiency, asserting that damages for injury to professional reputation are not excludable under section 104(a)(2).

The court stated that, after "careful consideration" of the Ninth Circuit's opinion in *Roemer*, and after "close scrutiny of all of our decisions in this area," it had concluded that, "for purposes of section 104(a)(2), there is no justification for continuing to draw a distinction, in tort actions, between damages received for injury to personal reputation and damages received for injury for professional reputation."<sup>139</sup> The court found that in determining excludability under section 104(a)(2), "the beginning and the end of the inquiry" is the determination of whether the amounts are damages for personal injuries.<sup>140</sup>

Significantly, the court acknowledged the conceptual error of confusing the nature of the injury with the consequences that flow from it. Although the *Threlkeld* court never mentioned the influence of the *Raytheon* "in lieu of what" analysis on its prior decisions, it convincingly repudiated it:

[T]he extent to which income is decreased, even though this may be the best measure of loss, in no way changes the nature of the claim. "It is simply not enough that the injury arose in connection with the taxpayer's business or his professional endeavor, or that the injury is somehow remotely capable of affecting his income." . . . Where . . . a taxpayer's injuries are nonphysical we have, in the past, ignored the personal nature of the claim and delved into an inquiry regarding the nature of the consequences of the injury.<sup>141</sup>

Having rejected the consequence-oriented analysis, the court determined that the question whether an injury is personal can only be determined

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139. Id. at 1298.

140. Id. at 1299.

141. Id. at 1299-1301 (quoting *Church v. Commissioner*, 80 T.C. 1104, 1109 (1983)).

by a consideration of "all the facts and circumstances."<sup>142</sup> The appropriate criterion in cases where there is a court judgment or an allocated settlement agreement is "the nature of the claim as defined under State law."<sup>143</sup> On the other hand, the court stated:

State law may be of limited assistance where, in a settlement, the claim settled is itself unclear. Similarly, State law is of little help where there are several claims, only some of which are for personal injuries. The State law classification of the various claims will be of no assistance in identifying the claim or claims or in carving up the damage recovery. In such cases we must look to various factors, including the allegations in the State court pleadings, the evidence adduced at trial, a written settlement agreement, and the intent of the payor. In a given case any one of these factors may be ultimately persuasive or ignored.<sup>144</sup>

Applying this analysis, the court noted that the parties had entered a written settlement agreement specifically allocating a fixed sum to injuries to Threlkeld's professional reputation arising out of an alleged malicious prosecution. The court observed that "the specific allocation in the settlement agreement does not necessarily control in deciding whether the claim being settled arises from a personal injury."<sup>145</sup> Instead, the state law characterization of the cause of action for malicious prosecution controls. Finding that Tennessee law treats an action for malicious prosecution as a personal injury action,<sup>146</sup> the court held that "all of the compensatory damages received by petitioner in settlement of his claim for malicious prosecution, including those allocated by the settlement agreement as compensation for injuries to professional reputation, are excludable from gross income under section 104(a)(2)."<sup>147</sup>

#### D. Recoveries for Civil Rights Violations

One obvious group of potential beneficiaries of the *Threlkeld* analysis are recipients of money damages under Title VII of the Civil Rights Act of 1964<sup>148</sup> and other civil rights provisions. Until very

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142. Id. at 1308.

143. Id. at 1306.

144. Id.

145. Id. at 1307.

146. The court cited cases recognizing the existence of the tort and its elements under Tennessee law, and based its conclusion that the action is one for personal injury on the fact that the one-year statute of limitations under Tennessee law for personal injury actions had been held to apply to malicious prosecution actions. Id. (cases cited).

147. 87 T.C. at 1308.

148. 42 U.S.C. §§ 2000(e)-2000(h)(6) (1981).

recently, the Service and the courts have refused to view money damages for prohibited employment discrimination as damages for "personal injuries," and have focused instead on the nexus between the damage awards (typically back pay or front pay) and the recipient's otherwise taxable earnings. Two recent Tax Court cases, *Bent v. Commissioner*<sup>149</sup> and *Metzger v. Commissioner*,<sup>150</sup> reverse this analysis and sanction exclusion from income of Title VII and section 1983<sup>151</sup> awards. Significantly, however, the most recent Tax Court decision, *Thompson v. Commissioner*,<sup>152</sup> appears to signal a retreat from *Bent* and *Metzger*. Both *Bent* and *Metzger* were appealed to the Third Circuit, which has affirmed the *Bent* decision, and an appeal of the Tax Court's decision in *Thompson* is likely. Careful analysis of the issue is therefore warranted.

### 1. Early Attitudes

The Service's first official ruling on the question of Title VII monetary awards is Revenue Ruling 72-341,<sup>153</sup> which did not mention section 104(a)(2). The ruling considered the tax consequences of money damages received by a group of individuals following a Title VII suit brought by the United States Government against the individuals' employer. The ruling stated that the "amount paid to each employee was based on a formula that took into account the difference between his actual earnings while in the employ of the corporation, and what his earnings would have been had he not been discriminated against."<sup>154</sup> The Service concluded that the awards were includable in the recipients' income under section 61 as "compensation."<sup>155</sup>

The only authority the Service cited was a 1941 Supreme Court decision, *Hort v. Commissioner*,<sup>156</sup> in which the Court held that a payment received by a lessor from a lessee for cancellation of a lease was taxable as ordinary income. The lessor had maintained that the payment was a nontaxable return of capital. The ruling correctly notes that the Supreme Court "looked to the nature of the item for which the damages were a substitute" and determined that what the lessor had received was a substitute for rent.<sup>157</sup> Because the rental payments,

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149. 87 T.C. 236 (1986), aff'd, 835 F.2d 67 (3d Cir. 1987).

150. 88 T.C. 834 (1987), appeal docketed, No. 87-1428 (3d Cir. July 16, 1987).

151. 42 U.S.C. § 1983 (1981).

152. 89 T.C. 632 (1987), appeal docketed, Nos. 88-3801 and 88-3924 (4th Cir. Jan. 6, 1988 and Jan. 28, 1988) (consolidated).

153. Rev. Rul. 72-341, 1972-2 C.B. 32.

154. Id.

155. Id.

156. 313 U.S. 28, 61 S. Ct. 757 (1941).

157. Rev. Rul. 72-341, 1972-2 C.B. 32.

if received, would have been taxable as ordinary income, the Court reasoned that the payment by the lessee to cancel the lease was similarly taxable.

*Hort*, an obvious precursor of the “in lieu of what” test, provides an answer only to the taxability of an award that is not governed by section 104(a)(2). The statute demands, however, that the threshold inquiry be made to determine whether the injury is “personal.” The question that must be answered is *not* whether money damages in Title VII actions are a substitute for compensation, but instead whether discriminatory employment practices constitute “personal injuries.”

The few courts that have considered this issue generally have been no more receptive to the notion of excludability than the Service. In *Hodge v. Commissioner*,<sup>158</sup> the Tax Court summarily rejected Hodge’s contention that a recovery for discriminatory employment practices is a personal injury recovery excludable under section 104(a)(2). For the court in *Hodge*, the analysis began and ended with its finding that the award represented back pay. The court’s inscrutable reasoning is contained in a footnote:

Petitioner cites a number of cases to support his argument that any amount recovered in a discrimination suit is excluded from income under sec. 104(a)(2), even if it is designated back pay. *These cases are not in point because they involve an entirely different issue which we need not reach in this case, namely, whether, as a matter of law, amounts recovered under the Civil Rights Act of 1964 may constitute personal injury damages within the meaning of sec. 104(a)(2).* We have concluded that back pay recovered under the Civil Rights Act of 1964 is taxable; in the second issue of this case, we decided that the entire amount recovered by the petitioner is, in fact, back pay. In the second issue, had we decided, as a matter of fact, that a portion of the recovery constituted personal injury damages instead of back pay, we would have also had to decide whether such recovery was excludable from gross income under sec. 104(a)(2). In view of our holding, we need not reach this issue.<sup>159</sup>

One can only speculate how many plaintiffs’ attorneys and their clients were persuaded by the *Hodge* court’s circular “reasoning” that it simply was not worth it to pursue the issue.

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158. 64 T.C. 616 (1975).

159. *Id.* at 619 n.7 (emphasis added).



In 1980 the Court of Claims (now the Claims Court),<sup>160</sup> in *Watkins v. United States*,<sup>161</sup> gave equally summary treatment to the question of whether Title VII awards are excludable. As the Tax Court had done in *Hodge*, the Court of Claims concluded that the recovery "was gross income because it was a back pay award."<sup>162</sup> Faced with this apparent unanimity among the Service and the courts with special tax expertise (the Tax Court and Claims Court), some courts responded with creative solutions. Finding it inequitable that plaintiffs be forced to pay a significant portion of their lump-sum recovery in taxes, and operating on the premise that a Title VII recovery is taxable, one federal district court concluded that "equity requires making a tax component a part of the back pay formula."<sup>163</sup>

Another federal district court took a novel approach. To ensure that the settlement award it approved would be tax-exempt, the court held that the award was a payment "to avoid the further costs and uncertainties of litigation," and was not, therefore, "a settlement of wage claims."<sup>164</sup> The court reasoned as follows:

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160. The Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, 96 Stat. 27 (1982), created a new Article I court, the United States Claims Court, that has essentially the same jurisdiction as the Trial Division of the former Court of Claims. That same Act also created a new appellate court, the United States Court of Appeals for the Federal Circuit, which is an Article III court that inherited the appellate jurisdiction of the former Court of Claims and the United States Court of Customs and Patent Appeals.

161. 223 Ct. Cl. 731 (1980).

162. *Id.*

163. *Sears v. Santa Fe Ry. Co.*, 30 Fair Empl. Prac. Cas. (BNA) 1084, 31 Empl. Prac. Dec. (CCH) ¶ 33, 388 (D. Kan. 1982), *aff'd*, 36 Fair Empl. Prac. Cas. (BNA) 783 (10th Cir. 1984), *cert. denied*, 37 Fair Empl. Prac. Cas. (BNA) 1216 (1985). The court noted the unfairness of taxing in a single year a recovery that should have been received over a number of years. In affirming the district court, the Tenth Circuit focused on the shortcomings of the then-available income averaging provisions to provide complete relief to all the class members:

The court-ordered back pay awards will likely place the living members of the class in the highest income tax bracket on much of the back pay they now receive. Even if the class members income average, they can not only consider the three years preceding the computation year. Apparently nearly 40% of the class members have died. Estates of deceased taxpayers are not eligible for income averaging . . . . We believe the trial court's inclusion of the tax component was an appropriate exercise of its discretion in the instant case.

*Sears*, 36 Fair Empl. Prac. Cas. (BNA) at 787. The repeal of the old income averaging provisions, I.R.C. §§ 1031-1035, by the Tax Reform Act of 1986 will compound this unfairness. Tax Reform Act of 1986 section 141(a).

164. *Sweet v. General Tire & Rubber Co.*, 28 Fair Empl. Prac. Cas. (BNA) 804, 813 (N.D. Ohio 1982).

While this Court is familiar with the revenue rulings which hold that, under certain circumstances, amounts paid in settlement of employment discrimination claims are wages, this Court holds them to be inapposite and not controlling in this case. This is not a case where the monetary award has been designated by the court, by the agreement or by law as back pay or wages. Nor is this a case where the agreement is silent on the nature of the award. This court has spoken on the nature of this award and declares it not to be "wages" . . . .

The fact that the awards are not "wages" does not necessarily mean that they are not excludable as income to the class members. . . . After examining the settlement agreement . . . , this Court concludes that the awards are not includable as gross income to the class members.<sup>165</sup>

Despite its dubious enforceability, this decision vividly illustrates the problem. If the designation of an award as back pay results in certain taxability, then any settlement should be designated by the parties and confirmed by the court as "in the nature of damages, not wages."<sup>166</sup>

Whether such precautions are necessary is currently unclear. In *Bent v. Commissioner*,<sup>167</sup> a decision filed nearly five months before *Threlkeld*, the Tax Court appeared to abandon the wages-oriented "in lieu of what" analysis, and in *Metzger v. Commissioner*,<sup>168</sup> filed April 9, 1987, the Tax Court reaffirmed the *Threlkeld* and *Bent* analysis in the context of a settlement of multiple actions based on federal and state antidiscrimination provisions. Although *Threlkeld*, *Bent*, and *Metzger* seem to signal a complete reversal of the Tax Court's refusal to analyze whether employment-related awards may be excludable as damages recovered for personal injuries, the Tax Court's most recent decision on this issue, *Thompson v. Commissioner*,<sup>169</sup> relies on *Hodge* and unabashedly reaffirms the "in lieu of what" test. An examination of these decisions follows.

## 2. *Bent v. Commissioner* (42 U.S.C. § 1983)

*Bent*, a high school teacher, sued under 42 United States Code section 1983,<sup>170</sup> alleging that the local school board's decision not to

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165. *Id.* at 814.

166. *Id.*

167. 87 T.C. 236 (1986), *aff'd*, 835 F.2d 67 (3d Cir. 1987).

168. 88 T.C. 834, appeal docketed, No. 87-1428 (3d Cir., July 16, 1987).

169. 89 T.C. 632 (1987), appeal docketed, Nos. 88-3801 and 88-3924 (4th Cir. Jan. 6, 1988 and Jan. 28, 1988) (consolidated).

170. At the time *Bent* was fired, section 1983 provided as follows:

rehire him constituted an impermissible abridgement of his First Amendment right to freedom of speech. After the trial court's finding of liability on the section 1983 claim, the parties settled. Bent excluded the settlement recovery from his income, and the Tax Court upheld the exclusion as proper under section 104(a)(2).

The *Bent* court first noted that the "essential" element of an exclusion under section 104(a)(2) is that the damages must derive from "some sort of tort (or tort-type) claim against the payor."<sup>171</sup> It then examined the Supreme Court cases analyzing the legislative history of section 1983 in order to "ascertain the nature of a sec. 1983 claim."<sup>172</sup> In holding the recovery excludable, the *Bent* court relied on the Supreme Court's 1985 decision in *Wilson v. Garcia*,<sup>173</sup> in which the Supreme Court concluded that "Section 1983 claims are best characterized as personal injury actions,"<sup>174</sup> as well as the Court's earlier pronouncement that section 1983 "was intended to [create] a species of tort liability."<sup>175</sup> The *Bent* court acknowledged that the recovery compensated Bent for lost earnings, but held that this was "*only an evidentiary factor*"<sup>176</sup> in computing the damages and did not alter the fact that the damages compensated Bent for a personal injury.

On December 15, 1987 the Third Circuit Court of Appeals affirmed the Tax Court decision in *Bent*. The court characterized Judge Chabot's opinion as "well-reasoned" and stated that it was "in accord with the reasoning and conclusions of Judge Chabot."<sup>177</sup> The court quoted the *Church* opinion for the proposition that not all personal injuries are physical injuries,<sup>178</sup> and quoted the Ninth Circuit's opinion in *Roemer* for the idea that "[t]he relevant distinction that should be made is between personal and nonpersonal injuries, not between physical and

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Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

42 U.S.C. 1983 (prior to 1979 amendment). According to the Tax Court, subsequent amendments to section 1983 did not apply. *Bent*, 87 T.C. at 245, n.7.

171. 87 T.C. at 244.

172. *Id.* at 246.

173. 471 U.S. 261, 105 S. Ct. 1938 (1985).

174. 87 T.C. at 248 (quoting *Wilson v. Garcia*, 471 U.S. 261, 280, 105 S.Ct. 1938, 1947 (1985)).

175. *Id.* at 249 (quoting *Carey v. Piphus*, 435 U.S. 247, 253, 98 S. Ct. 1042, 1047 (1978)).

176. *Id.* at 251 (emphasis added).

177. *Bent v. Commissioner*, 835 F.2d 67, 68 (3d Cir. 1987).

178. *Id.* at 70 (quoting *Church v. Commissioner*, 80 T.C. 1104 (1983)).

nonphysical injuries.”<sup>179</sup> The court then rejected the Commissioner’s argument that the damages were taxable based on lost compensation, quoting *Roemer* for the proposition that the “personal nature of an injury should not be defined by its effect.”<sup>180</sup>

Combining the *Bent* holding and analysis with the *Threlkeld* decision’s statement that “in all cases” involving an alleged personal injury exclusion will be permitted if the recovery compensates for “any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law,”<sup>181</sup> one must conclude that the long-standing refusal to permit exclusion of Title VII recoveries is in jeopardy. Indeed, very recently, in *Metzger v. Commissioner*,<sup>182</sup> the Tax Court reaffirmed and expanded its *Bent* holding to include monetary damages recovered in settlement of various civil rights claims, including specifically a Title II claim. More recently, however, in *Thompson v. Commissioner*,<sup>183</sup> the Tax Court retreated from this position and found a recovery under both Title VII and the Equal Pay Act taxable. An analysis of the *Metzger* and *Thompson* decisions follows.

### 3. Metzger v. Commissioner (*Title VII and 42 U.S.C. § 1983*)

Metzger, a college professor of Cuban national origin, was denied tenure despite a favorable recommendation by her department chairman. She then brought four actions before state and federal agencies and courts, alleging that the college’s denial of tenure constituted a breach of contract and violation of her constitutional and statutory rights to be free from discrimination based on her gender or national origin. Following a finding by the federal Equal Employment Opportunity Commission that there was reasonable cause to believe that the college discriminated against her based on her gender, the parties settled.

The settlement agreement recited that the college would pay Metzger \$75,000 in settlement of all her claims against the college, including both the breach of contract claims and those for violations of her civil rights. The agreement designated one-half her settlement amount as wages, but characterized this designation as having been made solely

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179. *Id.* (quoting *Roemer v. Commissioner*, 716 F.2d 693, 697 (9th Cir. 1983)).

180. *Id.* (quoting *Roemer v. Commissioner*, 716 F.2d 693, 699 (9th Cir. 1983)).

181. *Threlkeld v. Commissioner*, 87 T.C. 1294, 1308 (1986) appeal docketed, No. 87-1511 (6th Cir. May 26, 1987).

182. 88 T.C. 834 (1987), appeal docketed, No. 87-1428 (3d Cir. July 16, 1987).

183. 89 T.C. 632 (1987), appeal docketed, Nos. 88-3801 and 88-3924 (4th Cir. Jan. 6, 1988 and Jan. 28, 1988) (consolidated).

"for tax purposes."<sup>184</sup> Metzger excluded half the recovery from income, and the Service assessed a deficiency, asserting that the entire recovery was includable in her income.

The Tax Court, in an opinion by Judge Chabot, upheld Metzger's exclusion under the principles enunciated in *Bent* and *Threlkeld*. Under the approach outlined in *Threlkeld*, Judge Chabot first determined what claims the agreement settled. After reviewing the various actions and agency proceedings initiated by Metzger, the court concluded

that the settlement payment was made on condition that petitioner release her claims against the college based on a breach of contract, and on discrimination of the basis of sex and national origin in violation of petitioner's rights under the 13th and 14th Amendments to the United States Constitution, in violation of several Federal statutes and Executive Orders, and in violation of a State statute.<sup>185</sup>

The court next addressed the allocation of one-half the settlement amount to "wage claims" and found that the agreement's characterization of this allocation as being "for tax purposes only" amounted to a "disavowal" that "vitiate[d] the allocation."<sup>186</sup> Significantly, Judge Chabot specifically found further that even if he were to respect the allocation,

that would not advance the analysis; we still would have to examine the nature of the claims petitioner asserted and which petitioner and the college settled. In particular, we would have to determine whether the "wage claims" were an independent basis for recovery or were an evidentiary factor in determining the amount by which petitioner was damaged as a result of personal injuries which the college assertedly caused.<sup>187</sup>

Thus, even if the allocation were respected, it would not determine whether the amount labeled as settling "wage claims" is taxable, because the categories created ("wage claims" versus "all other claims") "cut across the statutory categories ('damages received . . . on account of personal injuries' and damages received on account of other matters)."<sup>188</sup>

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184. *Metzger*, 88 T.C. at 842. The college wanted to treat the entire \$75,000 as wages subject to withholding taxes in order to comply with its withholding obligations. Metzger preferred that as little as possible be withheld.

185. *Id.* at 849.

186. *Id.* at 850.

187. *Id.*

188. *Id.* at 849.

Having found that the allocation in the settlement agreement should be ignored, the court next determined the intent of the payor, as evidenced in various settlement documents and testimony of representatives of the college.<sup>189</sup> The court found that the college intended to settle all the issues raised by Metzger in the various state and federal proceedings.<sup>190</sup> Analytically, then, the next step was to determine the nature of the various claims settled.

Of the four state and federal actions instituted by Metzger, one (a suit brought in state court) alleged only breach of contract with no allegations of personal injuries. The remaining three, according to Judge Chabot, each involved alleged personal injuries. First, in a suit brought in federal court, Metzger sought redress under 41 United States Code sections 1981,<sup>191</sup> 1982,<sup>192</sup> 1983,<sup>193</sup> 1985(3),<sup>194</sup> and

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189. *Id.* at 850.

190. *Id.*

191. Section 1981 provides as follows:

All persons within the jurisdiction of the United States shall have the same right in every State and Territory to make and enforce contracts, to sue, be parties, give evidence, and to the full and equal benefit of all laws and proceedings for the security of personal and property as is employed by white citizens, and shall be subject to like punishment, pains, penalties, taxes, licenses, and exactions of every kind, and to no other.

42 U.S.C. § 1981 (1982).

192. Section 1982 provides as follows:

All citizens of the United States shall have the same right, in every State and Territory, as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold, and convey real and personal property.

42 U.S.C. § 1982 (1982).

193. Section 1983 provides as follows:

Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress. For the purposes of this section, any Act of Congress applicable exclusively to the District of Columbia shall be considered to be a statute of the District of Columbia.

42 U.S.C. 1983 (1982).

194. Section 1985(3) provides as follows:

(3) If two or more persons in any State or Territory conspire or go in disguise on the highway or on the premises of another, for the purpose of depriving, either directly or indirectly, any person or class of persons of the equal protection of the laws, or of equal privileges and immunities under the laws; . . . in any case of conspiracy set forth in this section, if one or more persons engaged therein do, or cause to be done, any act in furtherance of the object of such conspiracy, whereby another is injured in his person or property, or deprived of having and exercising any right or privilege of a citizen of the

1986,<sup>195</sup> claiming that the college's actions violated her thirteenth and fourteenth amendment rights to be free from discrimination on the basis of sex or national origin. Relying on the *Bent* holding that suits under section 1983 are personal injury actions, the court analyzed the remaining claims under sections 1981, 1982, 1985(3), and 1986 and concluded that "these claims also are in the nature of personal injury claims to which section 104(a)(2) applies."<sup>196</sup>

Metzger also instituted state and federal agency actions alleging discrimination in employment based on sex and national origin. As to her title VII charge filed with the federal Equal Employment Opportunity Commission, the court noted the "extensive comparison" of section 1981 and Title VII by the Supreme Court in *Johnson v. Railway Express Agency, Inc.*<sup>197</sup> and concluded that, as applied to the facts of this case, Metzger's Title VII claims "are as much [claims for] personal injuries as those for which petitioner sought relief in the Federal Court proceeding."<sup>198</sup> The court also found that Metzger's state agency action for prohibited employment discrimination was in the nature of a personal injury claim.<sup>199</sup>

Unfortunately, the *Metzger* court struggled to distinguish *Hodge*, in which it had held that back pay awards under Title VII are not excludable, and in so doing undermined its own previous insistence that the labeling of an award as compensating for lost wages does not control its treatment under section 104(a)(2). Unwilling to declare *Hodge* erroneously decided, Judge Chabot simply compared the holding and analysis of *Hodge* to the decisions in *Bent* and *Threlkeld*, and found that *Hodge* could not have held what it appeared to hold. After noting that in *Hodge*, "[w]e held that back pay is, by its nature, compensation

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United States, the party so injured or deprived may have an action for the recovery of damages occasioned by such injury or deprivation, against any one or more of the conspirators.

42 U.S.C. § 1985(3) (1982).

195. Section 1986 provides as follows:

Every person who, having knowledge that any of the wrongs conspired to be done, and mentioned in section 1985 of this title, are about to be committed, and having power to prevent or aid in preventing the commission of the same, neglects or refuses so to do, if such wrongful act be committed, shall be liable to the party injured, or his legal representatives, for all damages caused by such wrongful act, which such person by reasonable diligence could have prevented. . . . But no action under the provisions of this section shall be sustained which is not commenced within one year after the cause of action has accrued.

42 U.S.C. § 1986 (1982).

196. *Metzger*, 88 T.C. at 852.

197. 421 U.S. 454, 95 S. Ct. 1716 (1975).

198. *Metzger*, 88 T.C. at 856.

199. *Id.* at 858.

includable in income,"<sup>200</sup> Judge Chabot inexplicably balked at taking the next logical step.

We conclude that *Hodge* does not stand for the proposition that no damages received as a result of a proceeding under title VII are excludable under section 104(a)(2). Rather, excludability depends on what was the injury complained of, and the loss of income may merely be "an evidentiary factor" (*Bent*) or "the best measure of loss" (*Threlkeld*). In any event, *Hodge* is distinguishable from the instant case, in that, in the instant case (1) the evidence is clear that no effort was made to calculate the amount of back pay, (2) the evidence is clear that the college and petitioner sought to settle all the claims for a single lump sum, (3) the college believed that petitioner's contract claim might result in a liability of \$15-20,000, and (4) most of petitioner's claims were tort or tort-type claims on account of personal injuries and were not for back pay, while *Hodge's* claim, as we have noted, was only for a back pay differential.<sup>201</sup>

Thus, although the court found that Metzger's Title VII claim was in the nature of a personal injury claim, it refused to concede that all monetary recoveries under Title VII were excludable from income. The *Metzger* decision appears to endorse the proposition that a recovery of back pay in a Title VII action is not excludable under section 104(a)(2) if back pay is actually calculated by the parties and the recipient alleges no claims for personal injuries other than the claim of employment discrimination. The Tax Court's recent decision in *Thompson v. Commissioner*,<sup>202</sup> discussed at part 4 *infra*, considers the question of back pay awarded under the Equal Pay Act.

At least one category of Title VII cases, those involving sexual harassment or other "hostile work environment" claims, should always result in awards that are excludable under section 104(a)(2). In *Meritor Savings Bank v. Vinson*,<sup>203</sup> the Supreme Court recently rejected the notion that Title VII provides redress only for "tangible," "economic" losses as opposed to "purely psychological aspects of the workplace environment."<sup>204</sup> At issue in *Meritor* was whether sexual harassment is a form of sex discrimination prohibited by Title VII. The Court held that "a plaintiff may establish a violation of Title VII by proving

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200. Id. at 857.

201. Id. at 858.

202. 89 T.C. 632 (1987), appeal docketed, Nos. 88-3801 and 88-3924 (4th Cir. Jan. 6, 1988 and Jan. 28, 1988) (consolidated).

203. 106 S. Ct. 2399 (1986).

204. 106 S. Ct. at 2404.



that discrimination based on sex has created a hostile or abusive work environment."<sup>205</sup> The hostile work environment theory of recovery, under which the plaintiff need not establish any economic loss, has been applied in cases involving national origin,<sup>206</sup> race,<sup>207</sup> and religion.<sup>208</sup> The Supreme Court in *Meritor* noted and endorsed the broad applicability of the hostile work environment theory, and Title VII's applicability "beyond the economic aspects of employment" to protect employees' emotional and psychological stability.<sup>209</sup>

Title VII recoveries based on the hostile work environment theory, in which no economic loss need be shown, clearly qualify for exclusion under section 104(a)(2), because the nature of the claim is a tort-type personal injury. It is certainly arguable as well that *all* Title VII recoveries, including those designated as back pay, are excludable. In any Title VII action, the plaintiff's recovery is based on prohibited discrimination, which, under the *Threlkeld* standard, is an "invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."<sup>210</sup>

#### 4. Thompson v. Commissioner (*Equal Pay Act*)

In its most recent pronouncement on the scope of section 104(a)(2), *Thompson v. Commissioner*,<sup>211</sup> the Tax Court adopted the rationale suggested by the *Metzger* court in its effort to distinguish *Hodge* and held that back pay awarded under the Equal Pay Act<sup>212</sup> was not excludable under section 104(a)(2). On the other hand, the *Thompson* court found that liquidated damages received by the taxpayer pursuant to an Equal Pay Act provision<sup>213</sup> authorizing liquidated damages equal to 100% of the back pay award is excludable from income because it is a recovery for a personal injury.

Thompson was the lead plaintiff in a class action sex discrimination suit brought by women bindery workers against the United States

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205. 106 S. Ct. at 2405-06.

206. *Cariddi v. Kansas City Chiefs Football Club*, 568 F.2d 87, 88 (8th Cir. 1977); *Rogers v. EEOC*, 454 F.2d 234 (5th Cir. 1971), cert. denied, 406 U.S. 957, 92 S. Ct. 2058 (1972).

207. *Firefighters Institute for Racial Equality v. St. Louis*, 549 F.2d 506, 514-15 (8th Cir.), cert. denied, 434 U.S. 819, 98 S. Ct. 60 (1977).

208. *Compton v. Borden, Inc.*, 424 F. Supp. 157 (S.D. Ohio 1976).

209. 106 S. Ct. at 2405.

210. *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986), appeal docketed, No. 87-1511 (6th Cir., May 26, 1987).

211. 89 T.C. 632 (1987), appeal docketed, Nos. 88-3801 and 88-3924 (4th Cir. Jan. 6, 1988 and Jan. 28, 1988) (consolidated).

212. 29 U.S.C. § 206(d) (1987).

213. 29 U.S.C. § 216(b) (Supp. 1987).

Government Printing Office. The class sued and recovered under both Title VII and the Equal Pay Act. Thompson was one of a sub-class of workers who recovered under the Equal Pay Act. The entire class received partial recovery under Title VII, but the prevailing Equal Pay Act class members were not permitted to share in the back pay component of the Title VII award. Thus, the only issue before the *Thompson* court was the excludability of damages under the Equal Pay Act.<sup>214</sup>

Thompson asserted that her entire recovery, both the back pay award and the liquidated damages award, was excludable under the holding and analysis of *Threlkeld*. She maintained that she received these amounts "because of invasions of the rights granted to her by virtue of being a person."<sup>215</sup> The court summarized Thompson's position as follows:

Her argument is in effect that the payment was not based on a contract, expressed or implied, and that any amount received as the result of a suit which is not based on a contractual right is received as damages granted to the individual by virtue of being a person.<sup>216</sup>

The Service, of course, took the position that the entire recovery was taxable because it represented wages.

The court stated that Thompson "interprets our decision in *Threlkeld v. Commissioner* . . . far too broadly."<sup>217</sup> Thompson claimed that her recovery was for prohibited sex discrimination, which is in the nature of a tort. Rejecting this claim, the court stated:

[T]here is nothing in *Threlkeld v. Commissioner* . . . that converts a claim for back pay, because an individual has been underpaid for the work he has done, into a claim for damages for personal injury merely because the suit which involves such a claim may also have involved a tort-type action for personal injuries.<sup>218</sup>

The court then approvingly cited *Hodge* for the proposition that back pay is in the nature of wages and therefore not excludable under section 104(a)(2). Finally, the court stated that "the question to be

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214. A small portion of Thompson's recovery was awarded under Title VII for deprivation of opportunity for promotion. The court stated that "since the burden is on petitioner to show that any portion of the back pay was not granted under the Equal Pay Act we will treat the matter as if it was all received under the Equal Pay Act." 89 T.C. at \_\_\_\_.

215. 89 T.C. at \_\_\_\_.

216. *Id.*

217. *Id.* at \_\_\_\_.

218. *Id.* at \_\_\_\_.

asked is 'in lieu of what were the damages awarded.' If the conclusion is that the payment is in lieu of wages, the payment is not excludable under section 104(a)(2)."<sup>219</sup> The court concluded that the back pay award was not damages for personal injury, but instead a "payment for work" and not excludable.

On the other hand, the liquidated damages Thompson received pursuant to the Equal Pay Act were held to be excludable. The court noted that if Thompson had received this amount under either Title VII or section 1983, the recovery would "be held to be damages for personal injury"<sup>220</sup> under the *Metzger* and *Bent* holdings. This statement appears to undermine the court's holding concerning back pay, where the court's focus was more on the "in lieu of what" test than on the nature of the claim. Again the message is clear that although the federal antidiscrimination provisions provide redress for tort-type injuries, any recovery that is purely for back pay will be found taxable.

The court noted that the liquidated damages had been held to be compensatory rather than penal in nature, and that they were intended to compensate for intangible losses that were difficult to measure. According to the court, "[t]his is a further indication that the liquidated damages are intended as compensation for the sex discrimination which is a personal injury."<sup>221</sup> Thus, even though the liquidated damages are measured by the amount of back pay awarded, they are nevertheless awarded as damages for personal injury and are therefore excludable.

##### 5. Back Pay and Employer Withholding

Employers are required to withhold from an employee's "wages" statutory minimum amounts of federal income and other taxes, including the social security tax imposed pursuant to the Federal Insurance Contributions Act (FICA)<sup>222</sup> and that imposed by the Federal Unemployment Tax Act (FUTA).<sup>223</sup> Both the federal income tax withholding provision<sup>224</sup> and the FICA and FUTA withholding provisions<sup>225</sup> are based on "wages" paid by the employer to the employee. When an employer makes a back pay or front pay award to an employer pursuant to a settlement or judgment in an action under Title VII,

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219. *Id.* at \_\_\_\_ (citing *Fono v. Commissioner*, 79 T.C. 680 (1982), *aff'd*, 749 F.2d 37 (9th Cir. 1984)).

220. *Id.* at \_\_\_\_.

221. *Id.* at \_\_\_\_.

222. I.R.C. §§ 3101-3126 (1986).

223. I.R.C. § 3306 (1986).

224. I.R.C. § 3401 (1986).

225. I.R.C. § 3121 (1986) (FICA); I.R.C. § 3306 (1986) (FUTA).

the Equal Pay Act or any other antidiscrimination provision, should the employer withhold FICA and federal income tax?

The Service takes the position that "wages," for purposes of all three withholding provisions, includes back pay awards.<sup>226</sup> In a 1946 decision, the Supreme Court held that a back pay award under the National Labor Relations Act to a wrongfully discharged employee constituted "wages" for FICA purposes.<sup>227</sup> Very recently, the Sixth Circuit Court of Appeals considered a case in which the taxpayer conceded that his back pay recovery in a settlement of a Title VII action was taxable income and constituted "wages" for purpose of FICA and FUTA. In *Bowman v. United States*<sup>228</sup> the Sixth Circuit concluded that for FICA purposes, the award should be allocated to the years to which the back pay relates, rather than the year in which it is actually paid by the employer.<sup>229</sup>

No court has confronted the issue whether a back pay award that is held excludable from income under section 104(a)(2) is nonetheless "wages" for withholding purposes. Because some back pay awards may be excludable from income, at least under the Tax Court's analysis in *Metzger*, the interplay between the withholding provisions and section 104(a)(2) is certain to result in litigation.

#### *E. Tortious Breach of Contract*

The recent trend<sup>230</sup> toward imposition of tort liability in some types of suits for breach of contract could create serious analytical difficulties in separating taxable recoveries from nontaxable awards. For many years, breach of the implied covenant of good faith and fair dealing has supported recoveries of punitive damages in insurance contract cases in which the insurer is shown to have acted in bad faith.<sup>231</sup> Recently, some courts have imported this "bad faith" tort into other contexts, most notably for purposes of this discussion, the employment context.<sup>232</sup> Some courts have even upheld the award of punitive damages in arbitration.<sup>233</sup> Moreover, the Supreme Court has recently found that

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226. Rev. Rul. 80-364, 1980-2 C.B. 294.

227. *Social Security Bd. v. Neurotko*, 327 U.S. 358, 66 S. Ct. 637 (1946).

228. 824 F.2d 528 (6th Cir. 1987).

229. *Id.* at 530.

230. For an excellent discussion of this trend, see Note, Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing into the Commercial Realm, 86 Colum. L. Rev. 377 (1986).

231. See, e.g., *id.* at 381-84 (cases cited).

232. See *id.* at 384-86 (cases cited); S. Ashley, *Bad Faith Actions: Liability and Damages* ch. 11.

233. See *Jones*, *Win Punitive Damages in Arbitration*, 47 A.B.A. J. 86 (May 1, 1987).

one state's law permitting punitive damages for "bad faith" breach of contracts, although "identified" by the state supreme court with insurance actions, applies to any action for breach of contract.<sup>234</sup> Individuals who recover extra-contractual damages in such cases arguably can exclude the damages attributable to the tort element of the recovery under section 104(a)(2).

Because most recoveries for tortious breach of contract are punitive damages, the recipient must overcome two obstacles to exclusion under section 104(a)(2): first, he must establish that the award is on account of a personal injury; second, he must contend with the Service's current position that punitive damages are never excludable under section 104(a)(2). Recoveries for tortious breach of contract both epitomize the analytical problems created by section 104(a)(2) and provide a convenient crystallization of the fundamental policy issues. Despite the absence of detailed legislative history, it is highly unlikely that Congress in 1918 intended to sanction exclusion from income of recoveries for tortious breach of contract.<sup>235</sup> Nonetheless, because they necessarily involve a finding of tortious conduct, such recoveries are excludable under a literal reading of the statute and its implementing regulations. Perhaps because such recoveries are increasingly frequent and are usually punitive, the Service could bolster its efforts to ban punitive recoveries from the section 104(a)(2) exclusion by litigating a case involving punitive damages for tortious breach of contract. Such a case would strip the decades of ill-considered precedent and present the issues in their starkest form. First, is a recovery for tortious breach of contract, which is based upon (in the words of the regulation) a "tort or tort-type right" a personal injury within the meaning of section 104(a)(2)? If it is, are punitive damages recovered for the tortious breach excludable under section 104(a)(2)? This article suggests that the answer to the first question is "yes," and that Congress should amend section 104(a)(2) so that the answer to the second question is "no, if the damages were awarded only to punish the wrongdoer and not to compensate the victim."

### III. ARE PUNITIVE DAMAGES EXCLUDABLE? SHOULD THEY BE?

The same analytical approach that led courts to determine whether an injury was personal by inquiring whether the damages recovered

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234. *Pilot Life Ins. Co. v. Dedeaux*, 107 S. Ct. 1549, 1554 (1987) (construing Mississippi law).

235. But cf. *id.* (noting that "[a]s early as 1915 the Mississippi Supreme Court had recognized that punitive damages were available in a contract case when 'the act or omission constituting the breach of the contract amounts also to the commission of a tort.'") (citation omitted).

were in lieu of earnings has led the Service to conclude that punitive damages are never excludable under section 104(a)(2). Relying on dicta in footnote 8 of the Supreme Court's decision in *Glenshaw Glass Co. v. Commissioner*,<sup>236</sup> the Service in Revenue Ruling 84-108<sup>237</sup> ruled that punitive damages recovered in wrongful death actions (which qualify as personal injury actions under section 104(a)(2))<sup>238</sup> are includable in income because they are not a restoration of capital. A second basis for the ruling is that punitive damages are not excludable under section 104(a)(2) because they are not awarded "on account of" personal injuries. For the reasons discussed in Part II and amplified below, the return of capital analysis is irrelevant to the determination of whether a recovery is excludable under section 104(a)(2). The second basis for the Service's ruling, that punitive damages are awarded to deter conduct and not "on account of" personal injuries, also warrants scrutiny.

#### A. Footnote 8 of *Glenshaw Glass*

In its 1955 decision holding punitive damages for fraud and antitrust violations includable in income, the Supreme Court, in footnote 8 to the opinion, distinguished personal injury recoveries from recoveries for injury to property:

The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property . . . . Damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.<sup>239</sup>

Whether personal injury recoveries actually constitute nontaxable recovery of capital, and therefore are not "income" in the first instance, is irrelevant to a determination whether personal injury recoveries are excludable under section 104(a)(2), which is a specific statutory exception to the general rule of section 61(a). Moreover, section 104(a)(2) was not at issue in *Glenshaw Glass*. The only issue was whether the

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236. 348 U.S. 426, 431 n.8, 75 S. Ct. 473, 477 n.8, reh'g denied, 349 U.S. 925, 75 S. Ct. 657 (1955).

237. Rev. Rul. 84-108, 1984-2 C.B. 32.

238. See generally Rev. Rul. 84-108, 1984-2 C.B. 32 (compensatory wrongful death award excludable); Rev. Rul. 54-19, 1954-1 C.B. 177 (wrongful death proceeds do not constitute income) (now superseded and obsolete).

239. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 n.8, 75 S. Ct. 473, 477 n.8, reh'g denied, 349 U.S. 925, 75 S. Ct. 657 (1955).

punitive portion of antitrust and business fraud damages constituted "income."

Significantly, the actual (or compensatory) portion of the recovery in *Glenshaw Glass* was clearly and concededly includable in income, which is not the case when a personal injury plaintiff recovers both compensatory and punitive damages. The Supreme Court observed that "it would be an anomaly that could not be justified in the absence of clear congressional intent to say that a recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury."<sup>240</sup>

*Glenshaw Glass* thus held that punitive damages recovered for injury to business or property are income, and observed that in order for exclusion, clear congressional intent to exclude such damages from income would be required. In the personal injury context, there is a clear Congressional intent (section 104(a)(2) and its predecessors) to permit exclusion of "any damages" received "on account of" such personal injury. The inquiry is *not* whether damages received by a tort victim are income; the only question is whether they qualify for the statutory exclusion.

Secondly, the "long history of departmental rulings"<sup>241</sup> cited by the *Glenshaw Glass* Court as holding personal injury recoveries non-taxable under the return of capital analysis represent nothing more than an unnecessary exercise. Regardless of whether such recoveries have ever been properly characterized as income, the statutory exclusion of such recoveries from income has existed since 1918. Nonetheless, as the rulings cited by the Supreme Court illustrate, the applicability of the statutory exclusion has not always been acknowledged, due in large part to the notion that personal injury damages are not income.<sup>242</sup>

The *Glenshaw Glass* footnote contains a questionable general statement concerning the nature of personal injury damages: "Damages for personal injury are by definition compensatory only."<sup>243</sup> If this is true,

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240. *Id.* at 431, 75 S. Ct. at 477.

241. *Id.* at 431 n.8, 75 S. Ct. at 477 n.8.

242. The rulings cited by the *Glenshaw Glass* Court were: Sol. Mem. 1384, 2 C.B. 71 (1920) (holding damages for alienation of affection not excludable under the predecessor of section 104(a)(2) because, in the Solicitor's opinion, the exclusion applied only to damages for physical injuries); Sol. Op. 132, 1-1 C.B. 92 (1922) (effectively superseding Sol. Mem. 1384 by holding that damages for certain nonphysical personal injuries do not constitute income within the meaning of the sixteenth amendment); VII-2 C.B. 123 (1928) (damages paid to surviving spouse of person killed during sinking of steamship *Lusitania* not income); Rev. Rul. 54-19, 1954-1 C.B. 179 (wrongful death proceeds paid to beneficiaries of New Jersey decedent not income).

243. *Glenshaw Glass*, 348 U.S. at 431 n.8, 75 S. Ct. at 477 n.8.

then punitive damages are never excludable under section 104(a)(2) because, "by definition," they are not damages for personal injury. Damages for various personal injuries, the Supreme Court's statement notwithstanding, are *not* by definition only compensatory. For example, the Restatement (Second) of Torts includes compensation as only one of four purposes for which tort actions are maintainable,<sup>244</sup> and states that the "rules for determining the measure of damages in tort are based upon the purposes for which actions of tort are maintainable."<sup>245</sup> Moreover, as discussed in Part D, *infra*, although the *Glenshaw Glass* opinion refers only to the punishment/deterrent aspect of punitive damages, damages labelled as punitive or exemplary are awarded for other purposes as well.

*B. Revenue Ruling 84-108 and its Predecessors*

One year after the *Glenshaw Glass* decision, the Treasury Department promulgated a new regulation under section 61 that incorporated the *Glenshaw Glass* holding and stated that "punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income."<sup>246</sup> Two years later, the Service issued Revenue Ruling 58-418,<sup>247</sup> which considered the taxability of an amount received in settlement of a libel suit. The taxpayer had sought both compensatory and punitive damages for injury to his personal reputation. The Service concluded that the compensatory portion of the award was excludable from income, but that the portion representing punitive damages was includable in gross income.

In 1975, however, the Service reconsidered whether punitive damages received on account of personal injury were includable in gross income. In Revenue Ruling 75-45,<sup>248</sup> the Service addressed the taxability of a payment made by a corporate employer's insurer following the death of an employee who was killed while a passenger in the employer's airplane. Under the terms of the aircraft liability insurance policy held by the employer, the insurer would pay specified sums to

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244. Restatement (Second) of Torts § 901 (1977). The four purposes listed are:

- (a) To give compensation, indemnity or restitution for harms;
- (b) To determine rights;
- (c) To punish wrongdoers and deter wrongful conduct; and
- (d) To vindicate parties and deter retaliation or violent and unlawful self-help.

Id.

245. Id.

246. Treas. Reg. § 1.61-14 (1987).

247. Rev. Rul. 58-418, 1958-2 C.B. 18.

248. Rev. Rul. 75-45, 1975-1 C.B. 47.



individuals injured while passengers, or to those individuals' personal representatives in the case of death. Such payments were conditioned upon execution (by the injured party or the decedent's personal representative) of a complete release of all claims for damages against the insured. The release executed by the decedent's personal representative included all claims that could be brought under the state's wrongful death act, which had been interpreted as providing exclusively damages that "were punitive in nature."<sup>249</sup> Since 1974, when Massachusetts amended its wrongful death damages statute to provide for compensatory payments, Alabama is the only state whose wrongful death damages have been interpreted as punitive in nature.<sup>250</sup>

The Service concluded that the entire payment was excludable under section 104(a)(2). First, the Service ruled that the payment constituted "damages received" within the meaning of section 104(a)(2).<sup>251</sup> The Service then concluded that the entire payment was excludable from income under section 104(a)(2) because "under section 104(a)(2) any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income."<sup>252</sup>

Three years later, however, the General Counsel of the Internal Revenue Service issued a memorandum<sup>253</sup> stating that Revenue Ruling 75-45 was incorrect and should be revoked. The General Counsel opined that punitive damages received on account of personal injury or sickness were *not* excludable from income under section 104(a)(2).

In 1984 the Service issued Revenue Ruling 84-108,<sup>254</sup> which officially revoked Revenue Ruling 75-45. A 1983 General Counsel Memorandum<sup>255</sup> served as the official basis for this administrative action, although some impetus was undoubtedly provided by judicial asides in the Tax Court and Ninth Circuit opinions in *Roemer v. Commissioner*.<sup>256</sup> The Tax Court majority in *Roemer* noted that the exclusion from income of punitive damages was based solely on the Commissioner's "administrative discretion," and that the Commissioner's interpretation of "any damages" as including punitive damages "*arguably* comes within

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249. *Id.*

250. Morrison, Getting a Rule Right and Writing a Wrong Rule: the IRS Demands a Return on All Punitive Damages, 17 Conn. L. Rev. 39, 44 (1984).

251. Rev. Rul. 75-45, 1975-1 C.B. 47. This conclusion mirrored the Service's earlier holding in Rev. Rul. 58-578, 1958-2 C.B. 38 that such payments constituted "damages." Rev. Rul. 75-45 superseded Rev. Rul. 58-578.

252. Rev. Rul. 75-45, 1975-1 C.B. 47.

253. Gen. Couns. Mem. 37,398 (Jan. 31, 1978).

254. Rev. Rul. 84-108, 1984-2 C.B. 32.

255. Gen. Couns. Mem. 39,390 (Jan. 25, 1983).

256. 79 T.C. 398 (1982), rev'd, 716 F.2d 693 (9th Cir. 1983). See *supra* Part II C 1.

the language of section 104(c)(4) [*sic*].”<sup>257</sup> Dissenting Judge Wilbur was even more direct. He stated:

The law is clear that punitive or exemplary damages must be included in gross income, and I would so hold. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). Punitive damages are certainly not intended to compensate petitioner for a loss within the meaning of section 104. I realize that respondent has a revenue ruling that suggests a contrary result. Rev. Rul. 75-45, 1975-1 C.B. 47. . . . Nevertheless, the facts in Rev. Rul. 75-45, *supra*, are sufficiently different from those herein to permit the surprising but general language of the ruling to be disregarded for now.<sup>258</sup>

Perhaps the crowning blow was delivered by the Ninth Circuit, which reversed the Tax Court’s decision and ruled in favor of the taxpayer on the compensatory damages issue, but characterized the Service’s position regarding punitive damages as liberal.<sup>259</sup> Within six months of the Ninth Circuit’s decision in *Roemer*, the Service issued Revenue Ruling 84-108<sup>260</sup> and revoked Revenue Ruling 75-45.

Revenue Ruling 84-108 dealt with two identically situated widows who received settlement payments from the insurer of their deceased spouses’ employers. Both decedents had died in airplane crashes, and their employers’ insurance policies provided for payment only after the deceased employee’s personal representative executed a release of the employer from any wrongful death claims. One widow resided in Virginia, which characterizes wrongful death recoveries as compensatory, and the other widow resided in Alabama, which characterizes wrongful death recoveries as punitive. The Service ruled that the Virginia widow’s recovery was fully taxable because it constituted a recovery of punitive damages, which henceforth would be fully includable in income.

In holding that punitive damages are not excludable under section 104(a)(2), the Service cited two cases, *Glenshaw Glass* and *Starrels v. Commissioner*.<sup>261</sup> *Glenshaw Glass v. Commissioner* was cited for the propositions that punitive damages recovered in a fraud or antitrust action constitute income, are not a return of capital, and that they

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257. 79 T.C. at 408 (emphasis in original).

258. *Id.* at 414-15 (Wilbur, J., dissenting).

259. “Normally, an amount awarded for punitive damages is includable in gross income . . . . Nevertheless, the Commissioner liberally interprets § 104(a)(2) to exclude punitive damages as well as all compensatory damages where there has been a personal injury.” *Roemer v. Commissioner*, 716 F.2d 693, 700 (9th Cir. 1983).

260. Rev. Rul. 84-108, 1984-2 C.B. 32.

261. 304 F.2d 574 (9th Cir. 1962), *aff’g*, 35 T.C. 646 (1961).

are not designed to compensate the plaintiff for any loss, but instead are "extracted from the wrongdoer as punishment for unlawful conduct."<sup>262</sup> *Starrels* was cited for its application of the return of capital analysis. However, the Service misconstrued the *Starrels* holding.

In *Starrels* the taxpayer consented to the portrayal of her family in a motion picture, in exchange for a payment from the film company. The taxpayer maintained that the film would constitute an invasion of privacy, and that the advance payment to her therefore was excludable under section 104(a)(2). The court in *Starrels* ruled that the advance payments were not excludable because the taxpayer had not suffered a personal injury. Although it would seem that an invasion of privacy is no more or less a personal injury because it is compensated for in advance rather than after the fact, numerous cases have held that advance payments do not qualify for the statutory exclusion.<sup>263</sup> After noting the *Glenshaw Glass* discussion of *punitive* damages as not representing a return of capital, the *Starrels* court held that section 104(a)(2) "cannot support the exemption of payments made for injuries which have never occurred because such payments are not compensatory and hence cannot be considered a restoration of capital."<sup>264</sup> Interestingly, the *Starrels* court cited six revenue rulings and two cases (in addition to the *Glenshaw Glass* footnote 8 discussion) as authority for the return of capital analysis. Each of these authorities dealt with injuries to property; none involved alleged personal injury.

The Service's description of *Starrels* is misleading and incorrect. According to the Service, *Starrels*

*held* that damages paid for personal injuries are excluded from gross income under section 104(a)(2) because, in effect they restore a loss of capital. An award of punitive damages, however, does not compensate a taxpayer for a loss but adds to the taxpayer's wealth. Furthermore, punitive damages are awarded not "on account of personal injury," as required by section 104(a)(2), but are determined with reference to the defendant's degree of fault.<sup>265</sup>

There was no issue concerning punitive damages in *Starrels*, and its statements concerning the taxability of punitive damages are therefore

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262. 348 U.S. 426, 431, 75 S. Ct. 473, 477, reh'g denied, 349 U.S. 925, 75 S. Ct. 657 (1955).

263. See, e.g., *Roosevelt v. Commissioner*, 43 T.C. 77, 90 (1964); *Miller v. Commissioner*, 35 T.C. 631, 645 (1961), aff'd, 299 F.2d 706, 711 (2d Cir.), cert. denied, 370 U.S. 923, 82 S. Ct. 1564 (1962); *Meyer v. United States*, 173 F. Supp. 920 (E.D. Tenn. 1959).

264. 304 F.2d at 575.

265. Rev. Rul. 84-108, 1984-2 C.B. 32 (emphasis added).

nothing more than dicta in which the *Starrels* court cited dicta from *Glenshaw Glass*. Furthermore, the *Glenshaw Glass* characterization of personal injury awards as “by definition” compensatory only is questionable at best.<sup>266</sup> Thus, to remove punitive damages from section 104(a)(2)’s umbrella of “any damages” received “on account of” personal injury simply cannot be justified on the basis of an erroneous statement contained in dicta in a footnote in a thirty year old case that did not involve section 104(a)(2).

### C. *Burford v. United States*

The first and, to date, only consideration of Revenue Ruling 84-108 occurred, appropriately, in Alabama and in the context of a wrongful death recovery. Revenue Ruling 84-108 had specifically found that because Alabama law characterizes wrongful death recoveries as punitive in nature, such awards were not excludable from income under section 104(a)(2). In *Burford v. United States*,<sup>267</sup> Judge Lynne, in a memorandum opinion granting Burford’s motion for summary judgment, held that “Revenue Ruling 84-108 constitutes an unwarranted administrative amendment of the clear language of the Internal Revenue Code and cannot stand.”<sup>268</sup>

Judge Lynne noted that the proper starting place for construction of section 104(a)(2) is the statute itself, and found “the clear import” of section 104(a)(2)’s exclusion of “any damages” to include a “Congressional intent to exclude wrongful death proceeds—regardless of whether those proceeds are classified as compensatory or punitive—from gross income.”<sup>269</sup> Addressing Revenue Ruling 84-108, he found its reliance on *Glenshaw Glass* “misplaced,” principally because the compensatory damages involved in that case were unquestionably taxable. In a footnote, Judge Lynne disagreed with

the Service’s contention that footnote eight of the *Glenshaw Glass* opinion serves as authority for Rev. Rul. 84-108. The footnote is nothing more than dicta concerning punitive damages in a business context and offers no precedential or persuasive support for defendant’s position.<sup>270</sup>

The factual context of *Burford* may limit its applicability to other recipients of punitive damages. At issue in *Burford* was whether Alabama’s wrongful death statute, which has been interpreted as providing

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266. See *infra* Part D.

267. 642 F. Supp. 635 (N.D. Ala. 1986).

268. *Id.* at 636.

269. *Id.*

270. *Id.* at 637.

only punitive damages, is properly construed as providing damages "on account of" personal injuries. The court found that a construction of the statute that it did, in fact, provide such damages, was proper.

Only a contorted reading of [section 104(a)(2)] can lead to the interpretation that wrongful death actions [*sic*] are not received on account of personal injury. To contend that such proceeds are received only because of the tortfeasor's wrongful conduct and not because of a personal injury is neither logical nor realistic.<sup>271</sup>

Because the *entire* recovery under the Alabama wrongful death statute is punitive in nature, *Burford* is arguably distinguishable from a situation in which a plaintiff's recovery includes both punitive and compensatory elements. Nonetheless, *Burford* certainly provides direct support for the contention that any punitive damages awarded in a personal injury action are excludable. As Judge Lynne observed:

The Service is correct in its statement that Alabama wrongful death proceeds are intended to punish and deter wrongdoers. This characterization does not alter the inescapable fact that a wrongful death action arises only upon a person's death.<sup>272</sup>

Similarly, punitive damages in any personal injury action are awarded "on account of" the underlying injury, in the sense that they would not have been awarded but for the occurrence of the injury. The statutory language does not limit excludability to compensatory damages; it broadly excludes "any damages" received "on account of" personal injury. Congress could have limited the exclusion to compensatory damages but it did not. Nonetheless, the Service now reads "on account of" as meaning "to compensate for" and presumes that damages labeled as "exemplary" or "punitive" are never compensatory in nature.

#### *D. Extrapolating from a Unique Statute*

Both Revenue Ruling 75-45 and 84-108 dealt with proceeds received under Alabama's wrongful death statute, which is the only wrongful death statute that has been interpreted as providing only damages that are punitive in nature.<sup>273</sup> Both rulings correctly concluded that the payments under the insurance policies, which were conditioned on the decedent's personal representative releasing the insured from any claim for damages, were damages received within the meaning of section

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271. *Id.*

272. *Id.*

273. See *supra* text accompanying notes 248-59.

1.104-1(c) of the regulations. Therefore, the Service does take the position that punitive damages are "any damages received." Instead, it concludes that punitive damages (the only type of damages available under the Alabama wrongful death statute) are not excludable for two reasons: first, because they do not represent a restoration of capital; second, because they are not awarded "on account of" personal injuries but instead are designed solely to punish the tortfeasor. The first reason is incorrect because it simply ignores the existence of section 104(a)(2), which permits exclusion of items that would otherwise be includable as gross income under section 61. The second reason is simply an erroneous generalization that is incorrect even as applied to the facts of the ruling.

That the Service intends the rule of includability of punitive damages to apply in all cases cannot be gainsaid. Revenue Ruling 84-108 itself does not explicitly so state, but other evidence of the Service's intent abounds. First, Revenue Ruling 75-45, although issued in the factual context of the Alabama wrongful death statute, explicitly extended its holding to all punitive damages in personal injury actions. The Service concluded in that ruling as follows: "Therefore, under section 104(a)(2) any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income"<sup>274</sup> Revenue Ruling 84-108 revoked Revenue Ruling 75-45, thus rendering the latter's statement of general applicability void.<sup>275</sup> Furthermore, in subsequent rulings, the Service has characterized Revenue Ruling 84-108 as holding that "[p]unitive damages . . . are not excludable from income."<sup>276</sup>

In Revenue Ruling 84-108, the Service interpreted the words "on account of" personal injury to mean "to compensate for" personal injury. It then ignored existing case law in which Alabama courts construed the wrongful death statute as providing damages on account of personal injury. Because the Service was considering a unique statute, it need not have pronounced a rule of general applicability based on that statute. Indeed, as *Burford* correctly notes, Alabama courts have rejected the very premise of Revenue Ruling 84-108 by holding that recoveries under the wrongful death statute are not designed solely to punish the wrongdoer.<sup>277</sup> In a 1935 case, the Alabama Supreme Court

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274. Rev. Rul. 75-45, 1975-1 C.B. 47.

275. Rev. Rul. 84-108, 1984-2 C.B. 32.

276. Rev. Rul. 85-98, 1985-2 C.B. 51; see also Rev. Rul. 85-143, 1985-2 C.B. 55 ("This revenue ruling deals only with the compensatory damages. With respect to the taxability of the punitive damages, see Rev. Rul. 84-108, 1984-2 C.B. 32.") (libel suit involving compensatory and punitive damages).

277. *Burford v. United States*, 642 F. Supp. 635, 637 (N.D. Ala. 1986).

rejected the defendant's contention that wrongful death damages were awarded solely for willful or wanton conduct and not on account of bodily injury or death.<sup>278</sup> The court held that wrongful death damages under the Alabama statute, although labeled as "punitive," are awarded "on account of" personal injury or death.<sup>279</sup>

Although Alabama's wrongful death statute is unique in that it labels all damages recoverable thereunder as punitive, Alabama is not alone in awarding "punitive damages" that are designed, at least in part, to compensate the recipient. Courts and commentators have long recognized that, although punitive damages are *usually* awarded to punish the tortfeasor and deter future tortious conduct, they serve the additional functions of compensating the victim for wounded feelings and providing incentive for injured parties to sue by creating a fund for payment of attorneys' fees.<sup>280</sup> Indeed, some jurisdictions provide for damages that may be awarded either to punish the tortfeasor or to compensate the victim.<sup>281</sup> When a plaintiff recovers an award under such a statute, only the jury will know whether the amount was intended solely to punish the wrongdoer, or solely to compensate the plaintiff, or some combination of the two. Recipients of such awards could cite *Niles v. United States*<sup>282</sup> as authority for excluding the entire amount awarded under such a statute, since it is impossible to establish the jury's intent. On the other hand, the Service would undoubtedly take the position that the entire amount is includable in income under Revenue Ruling 84-108, because it bears the label "punitive" or "exemplary" damages.

In summary, the Service's interpretation of "on account of" personal injury as meaning "to compensate for" personal injury does not exclude all punitive damages from qualification under section 104(a)(2). Some jurisdictions permit the awarding of damages labeled as "punitive" or "exemplary" for compensatory purposes. Thus, Revenue Ruling 84-108, as applied to the facts of the Revenue Ruling itself, is incorrect even if section 104(a)(2) applies only to compensatory awards. Furthermore, there is no reason to read section 104(a)(2) as applying only to compensatory awards. If Congress intended to permit the exclusion of compensatory awards only, it could have so provided, just as it did so provide in section 104(a)(1), which provides that

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278. *American Fid. & Cas. Co. v. Werfel*, 230 Ala. 552, 162 So. 103 (1935).

279. *Id.* at 106.

280. See generally D. Dobbs, *Remedies* 205 (1976); W. Keeton, *Prosser and Keeton On the Law of Torts* 9, (5th ed. 1984); Long, *Punitive Damages: An Unsettled Doctrine*, 25 *Drake L. Rev.* 870, 875-76 (1976); Morrison, *supra* note 250, at 68-80.

281. See Morrison, *supra* note 250, at 69-73 (discussing Georgia law).

282. 710 F.2d 1391 (9th Cir. 1983). See *supra* text accompanying notes 61-62.

worker's compensation awards are excludable if received "as compensation for personal injuries or sickness."<sup>283</sup> The Service lacks the authority to amend section 104(a)(2) so as to exclude any category of damages, including punitive damages, that are awarded "on account of" personal injury. In the absence of any Congressional indication that it meant "on account of" to mean "to compensate for," such a restrictive interpretation is unwarranted and unenforceable.

#### *E. Hitting a Moving Target*

The laws governing punitive damages are not only diverse, but are increasingly the subject of proposed and actual revisions. In 1986, the legislatures of forty-one states enacted new legislation governing damages and restitution.<sup>284</sup> In February 1987 the American Bar Association's House of Delegates approved recommendations of the A.B.A. Action Commission to improve the Tort Liability System that included the following:

##### *Recommendation No.5*

The scope of punitive damages in cases involving damage to person or property should be narrowed through the following measures:

*e. To whom award should be paid.* After deducting costs and expenses, the court should determine what is a reasonable portion of the punitive damages award to compensate the plaintiff and counsel for bringing the action and prosecuting the punitive damages claim, with the balance of that award allocated to public purposes.<sup>285</sup>

Presumably, if every jurisdiction were to adopt the above recommendation, the Service would agree that the portion of the "punitive damages" that is allocated to the plaintiff is compensatory and therefore excludable. (The portion set aside for "public purposes" would, of course, present no problem because the plaintiff would have no right to receive it.) Yet, even this may not be a safe assumption in light of the Service's disregard of controlling precedent in Alabama concerning the nature of its wrongful death punitive damages.

Of course, it is unrealistic to expect uniformity in the fifty states (and the numerous federal damages provisions) concerning the stan-

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283. I.R.C. § 104(a)(1) (1986).

284. See, e.g., Thomas, Rights, Remedies, Restitution and "Reform"—the 1987 Torts Dialogue, 47 A.B.A. J. 8 (July 1, 1987).

285. Report to the House of Delegates of the American Bar Association Action Commission to Improve the Tort Liability System, 18-19 (February 1987); see Thomas, *supra* note 284.



dards governing punitive damages. Nonetheless, recipients of punitive damages—under the whole spectrum of existing statutes—must currently decide whether to follow the Service's *reasoning* (which would apparently permit exclusion of punitive awards that bear a compensatory element) or its *holding* (that punitive damages are not excludable) or, alternatively, whether to reject Revenue Ruling 84-108, as has the only court that has considered it. Because of the proliferation of new and stiffened penalty provisions in recent years,<sup>286</sup> the stakes are too high to justify or permit the current confusion to persist.

#### IV. CONCLUSION

The time has come for Congress to make its intentions known and for the Service to abandon its inconsistent positions concerning the effects of state law on the taxability of personal injury damages. Although it may be fisc-protective to maintain that state law labeling of damages as punitive or compensatory is dispositive, but that state law characterization of the nature of the claim is irrelevant, such fundamentally inconsistent positions must eventually be reconciled or one of them abandoned. Unless and until Congress amends section 104(a)(2) to provide for exclusion of compensatory awards only, all punitive damages received on account of an invasion of a tort or tort-type right should be excludable. Because the statutory language broadly applies to "any damages" received "on account of" a personal injury, the exclusion now encompasses types of awards that were nonexistent (or at most rare) when the statutory exclusion was first enacted. Punitive damages recovered in a breach of contract action for "bad faith" are excludable under the statute because they represent "any damages" that were recovered "on account of" what is now classified as a tort.

Amending section 104(a)(2) to provide an exclusion only for compensatory damages would not solve all the problems posed by the Service's current approach to the exclusion. Indeed, the most perplexing issue currently is whether damages compensating for lost earnings should be taxed. Although such awards have been excludable historically if recovered in connection with a physical injury, they are almost always held taxable when recovered for dignitary invasions, such as defamation or prohibited discrimination. In light of the plethora of cases currently being litigated on this issue, congressional action to clarify its position is long overdue.

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286. See generally, Greisman, Many Penalties Substantially Increased as a Result of the Tax Reform Act of 1986, 37 Tax. for Accountants 378 (1986); Silets, TEFRA Penalties in Action, 43d N.Y.U. Inst. on Fed. Tax ch. 9 (1985).